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TAX REFORM PROPOSALS—XXIII

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

OCTOBER 2, 1985

(Projected Effect on American Business and Its Impact on Foreign Tax Provisions)

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TAX REFORM PROPOSALS—XXIII

WEDNESDAY, OCTOBER 2, 1985

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman) presiding.

Present: Senators Packwood, Symms, Grassley, Long, Baucus, Mitchell, and Pryor.

[The press release announcing the hearing follows:]

[Press Release No. 85-068, Thursday, Aug. 9, 1985]

Tax Reform Hearings Before the Finance Committee to Continue in September and October

Further hearings before the Senate Committee on Finance on the President's tax reform proposal will continue in September and October, Chairman Bob Packwood (R-Oregon) announced today.

"The Committee made significant progress in its tax reform hearing schedule in June and July," Senator Packwood stated. "Although the Committee will focus much of its attention on deficit reduction in the month of September, tax reform hearings will continue and will take us further toward our goal of getting a tax reform bill to the President before the end of this session of Congress."

The hearings announced by Senator Packwood today include:

On Tuesday, September 24, Committee will hear from public witnesses on the impact of tax reform on tax-exempt bonds.

On Thursday, September 26, public witnesses will present their views on the impact of the President's tax reform proposal on financial institutions and on the mining industry.

On Tuesday, October 1, the Committee will receive testimony on the impact of the tax plan on the insurance industry.

On Wednesday, October 2, witnesses representing the public will present testimony on the projected effect that tax reform will have on American business generally and, in addition, its impact on the foreign tax provisions.

On Thursday, October 3, the Committee will consider the views of public witnesses on the impact of the President's tax reform proposal on our nation's regulated industries, as well as those provisions relating to the United States' possessions and its territories.

All of the hearings scheduled by the Committee will begin at 9:30 a.m. in Room SD-215 of the Dirksen Senate Office Building.

Senator Baucus. The hearing will come to order. Chairman Packwood is unable to be here at this moment. Senator Long will chair the hearing this morning. He is momentarily detained. In the meantime, in the interest of the best use of time, we will begin the hearing. The first panel consists of Richard Rahn, vice president and chief economist, Chamber of Commerce of the United States; Paul Huard, vice president for taxation and fiscal policy, National Association of Manufacturers; and Robert McIntyre, director of

Federal tax policy, Citizens for Tax Justice. Dr. Rahn, why don't you begin?

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, DC

Dr. **Rahn**. Thank you, Mr. Chairman. My name is Richard Rahn. I am vice president and chief economist of the Chamber of Commerce of the United States. Mr. Chairman, in the interest of time, I request that my entire testimony be made part of the record, and I will just summarize the principal parts. I am accompanied today by Rachelle Bernstein, manager of tax policy for the U.S. Chamber. The chamber is the world's largest business federation; and on behalf of the chamber, we thank you for the opportunity to express our views on the effect of tax reform on the economy. The chamber sincerely applauds the President and the administration for developing a comprehensive and constructive tax reform proposal. We are well aware of and greatly appreciate the enormous professional effort the Treasury staff has made in developing alternative proposals. In addition, we wish to commend those Members of Congress, Senator Bradley and Congressman Gephardt, Congressman Kemp and Senator Kasten, Congressman Moore and Senator Roth, and others, who have led the effort for constructive and needed tax reform. The U.S. Chamber of Commerce is an enthusiastic advocate of tax reform that would result in a higher standard of living for all Americans. Unfortunately, however, in the drive to pass a piece of legislation labeled tax reform, many seem to have forgotten the basic purposes of engaging in that tax reform effort. That is, to provide a simpler, more equitable tax system that would lead to a higher standard of living for all Americans. Economic growth is the most important criterion, because it is only through economic growth that we create jobs and lead a better life for all Americans and reduce poverty. We agree with the administration's assertion that their proposal will slightly increase the rate of economic growth; but we have argued that, if we are going to go through the massive undertaking of rewriting the tax system, we ought to shoot for higher rates than two-tenths of 1 percent per year of additional growth. If we set our sights higher, we can achieve much more. Unfortunately, the direction of many of the proposals seems to be going the other way. The Ways and Means staff proposal was released after the date for submission of our testimony to this committee, and we request that we be allowed to submit an addendum to this committee, commenting on the Ways and Means staff proposals.

Dr. **Rahn**. The Ways and Means staff proposals have moved much in the opposite direction. It is clearly an antigrowth proposal. It will greatly increase the cost of capital for equipment in a range of 11 to 24 percent. After the proposal was released, we asked Dr. Joel Prakken to analyze the macroeconomic effects of a Ways and Means staff option, using the Washington University econometric model. I will submit a detailed analysis to the committee, but in summary we find that it will reduce real GNP growth from one-half percent to nearly 1 percent, over each of the next 5 years. It will greatly reduce the amounts of the domestic private investment from 3 to 4½ percent for each of the next 5 years. It will reduce the investment in equipment from 2.8 to 5.8 percent over each of the next 5 years. This is not the direction, I believe, the country ought to be going in. Our testimony details our specific suggestions for improving the administration's proposal to make it more progrowth, to create additional jobs, to enhance productivity, to enhance capital formation, and very importantly these days, to increase our international competitiveness. Unfortunately, both the administration and the Ways and Means Committee proposal would reduce the ability of American firms to compete overseas rather than to enhance their ability to compete. You will be hearing more today from a number of business witnesses on the international competitive aspects, and we have more details in our own testimony. Finally, we have just completed a survey of a number of our members to find out what the impact is on investment decisions of the effort before Congress to reform taxes. We had asked our members: Has your firm been delaying investment spending in plants and equipment because of uncertainty caused by the tax bill pending before Congress? Of the sample, approximately 40 percent answered "yes" that it was having an effect; 60 percent said no; some were accelerating their investment decisions; but given the time limits placed in the Ways and Means Committee proposal this past week, we would expect that more now would be delaying their investment decisions. So, we certainly encourage the committee and the Congress to try to work through tax reform in the most expeditious manner possible because, if it drags well into next year, we believe it could have a very adverse effect on U.S. investment decisions. Thank you, Mr. Chairman.

Senator BAUCUS. Thank you, Dr. Rahn.

Mr. Huard.

[The prepared written statement of Dr. Rahn follows:]

STATEMENT
on
TAX REFORM
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn
October 2, 1985

I am Richard Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. I am accompanied today by Rachelle Bernstein, Manager of the Tax Policy Center for the Chamber. The Chamber is the largest federation of business and professional organizations in the world. On behalf of the Chamber, I thank you for the opportunity to express our views on the effects of tax reform on the economy.

The Chamber sincerely applauds the President and his Administration for developing such a comprehensive and constructive tax reform proposal. We are well aware of and greatly appreciate the enormous professional effort the Treasury staff made in developing alternative proposals. In addition, we wish to commend those members of Congress, Senator Bradley and Congressman Gephardt, Congressman Kemp and Senator Kasten, Congressman Moore and Senator Roth and others who have led the effort for constructive and needed tax reform.

The U.S. Chamber of Commerce is an enthusiastic advocate of tax reform that would result in a higher standard of living for all Americans.

As should be apparent to all by now, tax reform, at least in terms of the specifics and mechanics of any particular plan, means many things to many people, and these differences tend to manifest themselves as soon as a specific proposal is introduced. In focusing upon these differences, one easily lose sight of the overriding purpose of tax reform and the objective that unites the disparate elements of our society in support of the general notion of tax reform. Americans from all walks of life support tax reform because they believe that it will enhance their material well-being by eliminating onerous provisions and creating opportunity for economic advancement. Absent these objectives, tax reform would be an unproductive exercise, the costs of which, in both political and economic terms, would vastly outweigh the benefits. In other words, all endorse the notion of tax reform if it will lead to a stronger economy and an improvement in the standard of living.

In the context of reforming a body of law as complex as our tax code, this, of course, is a rather amorphous objective and, as such, requires the formulation of more specific and easily measurable standards. The U.S. Chamber, which represents the broadest spectrum of American business, believes that such a standard can be operationally defined by reducing the goal of economic growth into its component parts and using these as standards by which to measure the desirability of any reform proposal. However, any reform proposal must contain fair transition rules. For purposes of our evaluation, we have selected the following four contributors and components of growth as the key standards by which to evaluate any tax reform proposal. They are:

1. Capital Formation
2. Technological Advancement
3. International Competitiveness, and
4. Job Creation

It is our belief that any tax reform proposal which does not enhance the prospects of each of these component objectives is a costly exercise with limited benefits to the American people.

In our view, the Administration's tax reform proposal improves our present system but does not take that extra step which would make the package a truly growth-inducing set of reforms. Indeed, as is clearly demonstrated later in this statement, most of the econometric simulations performed on the package, including the Treasury's own projections, indicate that the package, as presently constituted, only moderately advances economic growth beyond what is expected under current law. If members of Congress are to make the difficult decisions necessary to enact tax reform, we believe they should strive for greater economic growth than would result from the Administration's proposal.

It is in the spirit of setting our sights higher than this that we offer a series of proposed changes to the package. As you approach the process of fundamental tax reform, we encourage you to back up for a moment and establish as your objective the goal of more rapid economic growth as defined by the four contributing components set out above. Specifically, we urge you to establish as your goal a real GNP growth path that is at least one percentage point higher than what would otherwise occur. With the unemployment rate slightly in excess of seven percent, with inflation under control and with industry operating at about eighty percent of capacity, we believe that the goal of an additional one percent real growth per annum for the remainder of the decade is feasible and worthy of your efforts. A well-constructed package of tax reforms, combined with spending restraint and stable monetary policy, could easily achieve this.

If dynamic revenue estimates were utilized, the revenue loss associated with the individual rate reductions in the Administration's proposal would be $104 billion less than Treasury predicts by using static estimates. As has historically been proven, this is because when tax rates are cut the wealthy pay more in taxes because they invest more in income producing activities. Similarly, reductions in capital gains tax rates increase capital gains tax revenues. The Chamber supports the Administration's proposed individual tax rate reductions and reductions in capital gains tax rates.

The Administration's proposed capital cost recovery system (CCRS) would substantially raise the cost of capital for equipment, which could result in billions of dollars of lost investment, causing the economy to grow more slowly than it otherwise could. We strongly urge the Congress to avoid raising the cost of capital by retaining an adequate cost recovery system.

The windfall tax on excess depreciation presents an excessively unfair burden on capital investment. Firms with older investments will suffer cashflow problems as a result of windfall tax payments, leaving less capital available for new investments. Reduced new investment will cause a business slowdown, especially during the three year period when the windfall tax provision is in effect.

The advantages of this specific goal are two-fold. First, the reform process is placed in its proper perspective. Without a well-defined growth goal, the process of tax reform in a static context could easily degenerate into an exercise of reshuffling the tax burden in which the strong and influential will gain at the expense of the weak and less-well organized segments of our society. Second, by establishing the goal of greater economic growth, we also dispense with the fruitless and counter-productive bickering over static revenue gains and losses.

As estimates by official government agencies have demonstrated, the revenue gains from economic growth are substantial and would offset, by a wide margin, the static revenue losses that would arise from the many improvements that could be made in the Administration's plan. In December 1984, the Office of Management and Budget estimated that an additional one percentage point increase in real economic growth would increase government revenues by $75 billion over the next three years. A similar analysis by the Congressional Budget Office in February 1985 found that an extra one percentage point increase in GNP growth would raise an additional $98 billion in revenues over the next three years. In either case, the gains are substantial and provide a wide margin in which to work in developing a tax reform package that will spur the economy forward.

Can this be achieved? We believe so, for we have done so in the past. The remainder of this extensive statement is devoted to the numerous suggested changes in the plan. We are confident this will increase growth beyond the modest baseline used by the Treasury in estimating the gains and losses from the many changes they propose.

Capital formation increases productivity and output and fosters the international competitiveness of American business. Technological advancement creates new products and markets, enhances productivity and aids U.S. international competitiveness. Increased labor force participation, whether by job creation or increased work weeks, creates larger markets and more output.

The tax law affects each of these determinants of economic growth. Capital cost recovery allowances affect the cost of capital and, therefore, the level of investment in plant, equipment and structures. Capital gains tax rates affect the cost of capital and the after-tax reward to risky activities such as research or the launching of new products or enterprises. Consequently, the tax treatment of capital gains has strong effects on investment levels and the degree of technological innovation. Marginal tax rates influence the cost of capital, the after-tax return to additional work and virtually every other economic activity. Lower marginal tax rates will reduce the tax disincentive to invest and to work. The tax treatment of international business, particularly of income earned abroad, has important effects on the competitiveness of U.S. business. Finally, the tax treatment of savings has important effects on the level of saving and whether the economy creates sufficient capital to sustain high rates of economic growth.

Revenue Neutrality

Tax reform should be revenue neutral. The reformed tax code should raise the same revenue as present law. But most revenue estimates are based on the totally unrealistic assumption that people do not change their behavior in response to changes in the tax law. Both the Joint Committee on Taxation and the Treasury revenue estimators live in the fantasy world of static revenue estimates.

We believe that revenue estimates should be conducted on the basis of what happens in the real world. Revenue estimates should take into account the fact that taxpayers change their behavior in response to changes in the tax law. Granted, this is a difficult and inexact process. But it is better to be inexactly correct than precisely incorrect.

It is simply indefensible that revenue estimates that everyone acknowledges to be incorrect are driving public policy. When billions of dollars and the future of the American economy are at stake, it makes sense to go that extra mile and try to predict what will actually happen. The country can ill afford the short cut of static revenue estimates.

Dynamic revenue estimates would show that lower tax rates lose less revenue than Joint Committee static estimates. In fact, as demonstrated elsewhere in this testimony, lower tax rates sometimes even increase government revenues. Dynamic revenue estimates would show that repeal of the combination of ACRS and ITC is more likely to lose revenue than raise the billions claimed.

It was static revenue estimates that fueled the drive to enact TEFRA and the Tax Reform Act of 1984. Static revenue estimates lead the Congress to believe that TEFRA, the largest tax increase in the history of the United States, would substantially reduce the deficit. Instead, the deficit soared - in part because of TEFRA's adverse economic impact.

The impact of a tax rate increase on the federal budget designed to raise $20 billion in taxes on a static basis will neither increase revenues nor lower the deficit by that much. Rather, the impact on the deficit will be lower than the $20 billion for two reasons: (1) because the tax base has been reduced, revenues raised will be less than $20 billion; and (2) outlays for social insurance programs will have risen.

What this shows is that "static" revenue estimates can be very misleading indeed. We know from experience that the effect of tax rate increases on revenues and the deficit will, in every case, be different from the static estimate. The only way to approximate the actual impact of changes in fiscal policy is to perform a so-called "dynamic" analysis of the particular tax or spending change. A dynamic analysis takes the static estimate one step further - it asks what the impact of the proposed change on the overall economy would be, and how these induced changes in overall economic activity will then affect revenues.

In order to approximate the dynamic impact of a fiscal policy option, the static estimates are fed through an econometric model which simulates the workings of the real economy. Such a model is a system of mathematical equations, based largely on historical relationships which apply to the economy at large.

A properly constructed dynamic econometric analysis will not necessarily give precisely correct tax revenue and deficit figures resulting from tax reform. But, they are certain to be far less incorrect than the static figures.

If we really want tax reform that will stimulate economic growth, then it is imperative that Congress and the Administration get away from the "static revenue neutral" charade. Instead, they should focus on how both individual and business taxpayers are apt to alter their behavior as a result of any proposed change, and to enact those changes that will have a positive impact on the many components of economic growth and the tax base.

I. Capital Formation

A. Capital Cost Recovery Allowances

For many years, capital investment had been singled out for unfavorable tax treatment. While most business expenses were deductible in the first year, capital expenses had to be deducted over a number of years without adjustment for inflation and the opportunity cost of money. Since the tax code ignored this "time value of money", it was biased against long term investment.

Requiring capital costs to be recovered over a long period of time, without adjustment for the time value of money, increases the after-tax cost of the machine or structure being purchased. Adverse tax treatment forces investors to require a higher before-tax return from depreciable property in order to receive the same after-tax return. Consequently, capital investment is less attractive, investment declines and productivity and economic growth are reduced.

An example will make it easier to understand this problem. Suppose Sandra decides to go into the secretarial service business. She spends $8,000 for a word processor. In the first year, she receives $7,000 from customers and has $2,000 in expenses such as telephone, advertising, paper and ribbons. She is still $3,000 behind. She has not made a profit and should not be taxed because she has not recovered her capital expense -- the price of the word processor. Advocates of so-called "economic depreciation" would argue that she has made a substantial profit, unless the market value of the machine has declined by over $3,000. Although literally no-one knows the market value of Sandra's machine until she has actually sold it, economic depreciation advocates argue that the tax system should assume a figure that would be applied to all assets. Table I reflects the differences between expensing and the Capital Cost Recovery System (CCRS) proposed by the Administration.

TABLE I

COMPARISON OF EXPENSING AND CCRS
Year One

EXPENSING		CCRS	
Revenue:	7,000	Revenue:	7,000
Expenses:		Expenses:	
word processor	8,000	word processor	1,760[1]
miscellaneous	2,000	miscellaneous	2,000
	10,000		3,760
Taxable Income:	-3,000	Taxable Income:	3,240
Year Two			
Revenue:	7,000	Revenue:	7,000
Expenses:		Expenses:	
miscellaneous:	2,000	miscellaneous	2,000
		wordprocessor	2,880
			4,880
Taxable Income:	5,000	Taxable Income:	2,120
less year one	3,000		
	2,000		

Under expensing, Sandra would not pay taxes until she has paid all of her expenses, including capital expenses, and actually begins making a profit. Under economic depreciation, she would pay taxes long before she has paid her expenses.

---

[1] The Administration proposal would allow the first $5,000 of equipment to be expensed, as does current law. We have not included that exception in this example in order to be able to show a clearer difference between the concepts of depreciation and expensing.

1. The Accelerated Cost Recovery System Caused Record Capital Formation

The Accelerated Cost Recovery System (ACRS) was a cornerstone of the Economic Recovery Tax Act of 1981 (ERTA), and exceeded the goals of even its most optimistic supporters. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS cut the cost of capital and allowed businesses to make the investment in plant and equipment needed to drive the recovery. ACRS, combined with the investment credit, is approximately equivalent to expensing in present value terms, i.e. when one takes into account the time value of money and inflation. As the table below illustrates, the combination of ACRS and the investment tax credit successfully reduced the tax bias against investment and caused nonresidential fixed investment (plant and equipment) to increase by 31.5 percent in the ten quarters since the recovery began in the fourth quarter of 1982. This is the highest rate of capital formation in any post-war recovery. The average increase during post-1950 recoveries is 16.2 percent, half of the present rate.

TABLE II
CAPITAL FORMATION DURING THE RECOVERY

Recovery Began	10-Quarter % Increase in Fixed Nonresidential Investment	Investment/GNP Ratio 10 Quarters after Trough
1949	8.0	8.9
1954	19.9	9.7
1958	15.3 (8 quarters)	9.7 (8 quarters)
1961	11.8	9.1
1970	25.4	11.1
1975	17.0	10.2
Average of all 6	16.2	9.8
1982 most recent	31.5	12.8

Note: 1958 recovery did not last 10 quarters

Dr. Michael Boskin, of Stanford University, estimates in his study of investment incentives for the National Chamber Foundation that "ACRS and the ITC was responsible for about 25 percent of the net investment in the 1982-84 period."[1] Thus, if the investment aspects of ERTA had not been passed GNP would have been approximately 79 billion dollars less (1982-1985) and the federal government would have received 33.5 billion dollars less in tax revenue.

Dr. Boskin estimates the net cost of capital for equipment due to ERTA/TEFRA was reduced by 3 percent, but under the Administration proposal the net cost of capital for equipment will be increased by approximately 6 percent.

Given past history, the Chamber believes that the proposed increase on the net cost of capital for equipment will not cause an increase in tax receipts, as portrayed by Treasury's static model, but will, in fact, cause a revenue loss. The precise amount of the loss is subject to debate, but again the evidence is overwhelming that the proposed increase in the cost of capital for equipment will result in lower not higher revenues. More importantly, the proposed change will result in lower productivity growth, reduced international competitiveness reduced job creations, and a reduced rate of real economic growth. Dr. Boskin's results are shown in more detail in Table III.

TABLE III
ECONOMETRIC ESTIMATES OF
EFFECT OF ERTA/TEFRA ON INVESTMENT

YEAR	% INCREASE GROSS INVESTMENT	INCREASE ($ Billions)	INCREASE AS % OF NET INVESTMENT
1982	2.24%	$9.53	15.8%
1983	3.92	14.42	29.0
1984	7.36	31.93	29.8
1985 (est.)	---	22.75	---

Source: M. Boskin "Impact of the 1981-1982 Investment Incentives on Business Fixed Investment", (National Chamber Foundation, 1985).

Other economists, such as Leonard Sahling and M.A. Akhtar of the Federal Reserve Bank of New York, estimate that over 40 percent of the increase in producer's durable equipment was caused by the ERTA/TEFRA tax rate reductions.

Chart 1 graphically compares investment in the last recovery to the average since World War II Chart 2 illustrates that investment as a percentage of GNP is at a record high level due to ACRS.

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[1] M. Boskin, "Impact of the 1981-1982 Investment Incentives on Business Fixed Investment", (National Chamber Foundation, 1985)

Chart 1

Investment in Producers'

Durable Equipment

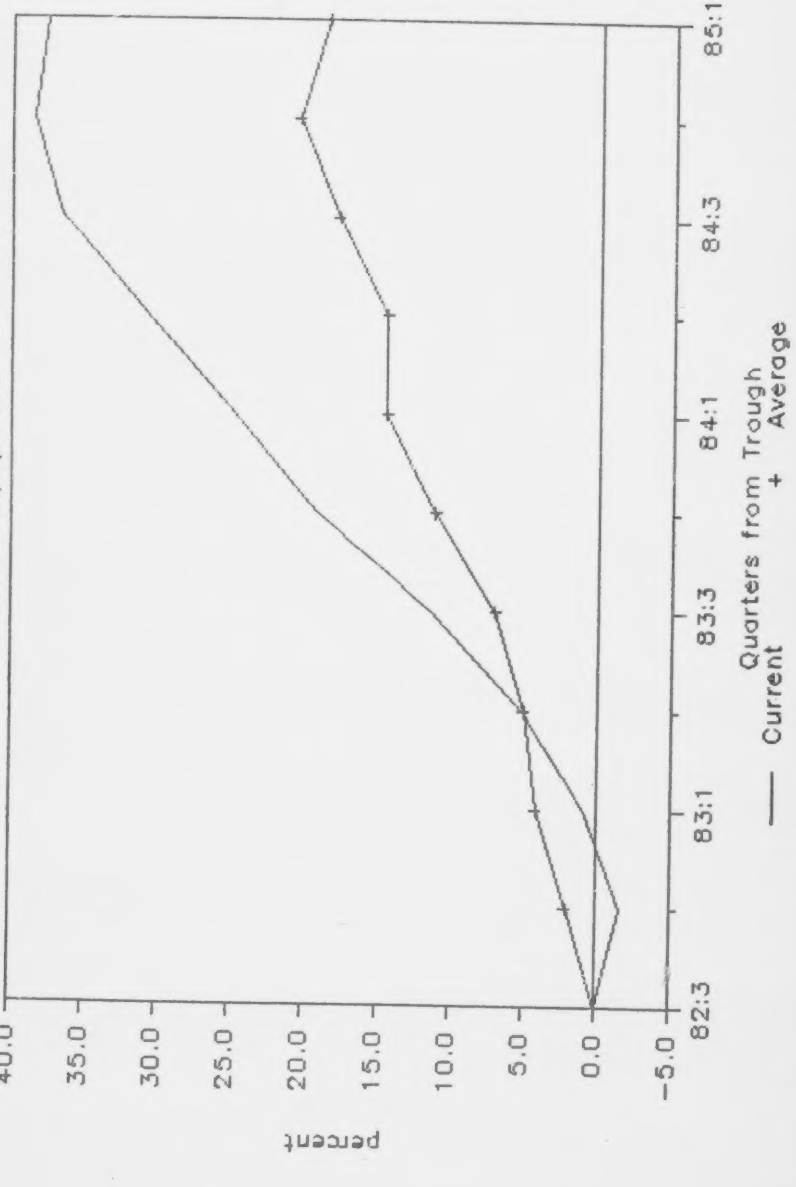
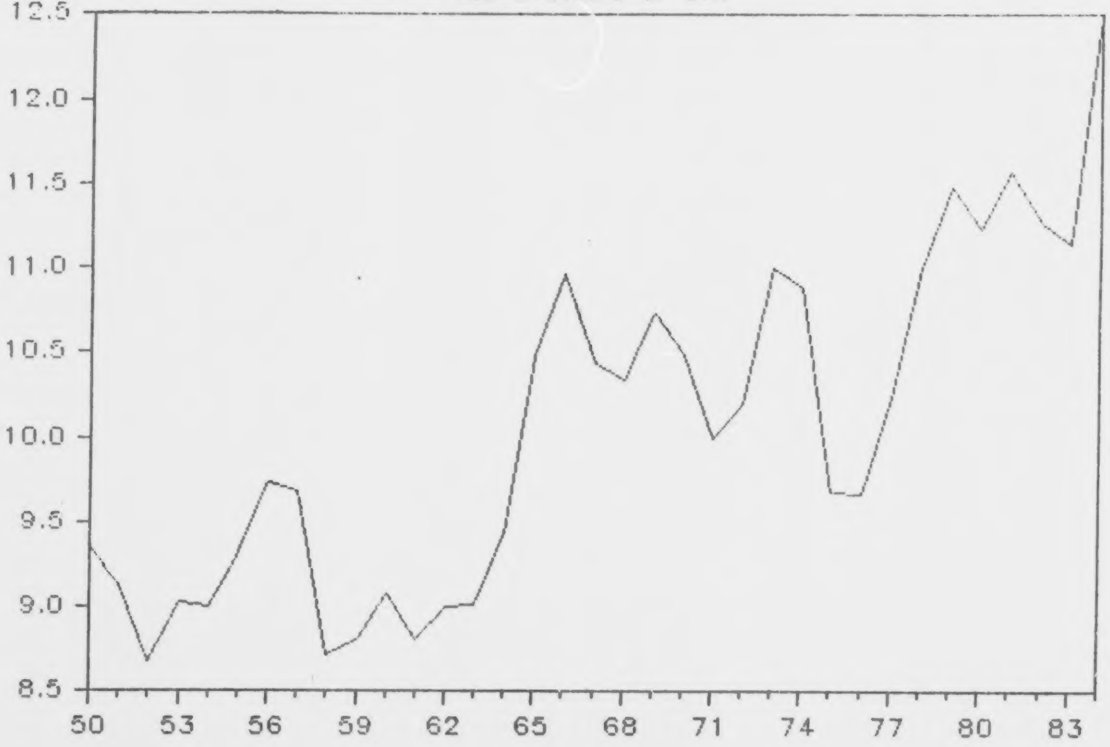


Chart 2



Business Fixed Investment

as a Share of GNP

As Table IV illustrates, capital formation did not fall nearly as much as is usual during the last recession because of ACRS. This is because ACRS became effective just after the recession began and substantially mitigated the adverse effects of the recession.

TABLE IV
CAPITAL RECOVERY DURING THE RECESSION

Quarters After Peak	Average of Seven Postwar Recessions	Last Recession
1	-2.6%	+0.7%
3	-6.4%	-6.3%
5	-14.2%	-9.1%

Note: Only the 1975 recession lasted five quarters.

Increased capital formation boosts productivity, employment and competitiveness. Because pre-ERTA allowances were insufficient, the U.S. economy had stagnated and become uncompetitive. Our capital stock was much older than our trading partners' because our allowances had been insufficient for decades. Any further cutbacks in depreciation allowances will undermine the progress made to date.

The tax law has undergone four changes over the last seven years -- often several major changes in one year. Businesses have watched tax cuts enacted only to be undone within the year. This sort of activity makes planning difficult. Moreover, it makes every tax reduction suspect and therefore reduces the efficacy of its incentives.

Many businesses choose not to take "advantage" of new tax incentives because they expect the new advantages to disappear. They will not make marginal investments on the basis of tax provisions if they expect them to disappear, thus rendering their investments unprofitable.

ACRS under ERTA was simple. The Tax Equity And Fiscal Responsibility Act of 1982 (TEFRA) introduced more complexity. The Tax Reform Act of 1984 added amazingly complex rules. This ever-increasing complexity is rapidly eroding the progress made in 1981.

2. Capital Cost Recovery Under Tax Reform

Many tax reform proposals reduce capital cost recovery allowances for equipment and would harm certain types of investment. The President proposes the Capital Cost Recovery System (CCRS). Bradley-Gephardt would replace ACRS and the ITC with the Simplified Cost Recovery System (SCRS). SCRS would employ lives similar to the old ADR class lives but allows a 250 percent declining balance method. The Real Cost Recovery System (RCRS) is the system originally proposed by the Treasury Department in November. RCRS is employed for a number of purposes, including measuring tax preferences, in the President's proposal.

Proposals like Kemp-Kasten, Roth-Moore and others, however, would not substantially increase, and would sometimes reduce, the cost of capital. Kemp-Kasten's Neutral Cost Recovery System (NCRS) would provide the present value equivalent of expensing while Roth-Moore would phase-in actual expensing.

Table V reflects the effect of the various proposed capital cost recovery plans on the after-tax cost of capital. The Table reflects the effect of corporate tax rate reductions, dividend deductibility, the investment tax credit and depreciation allowances.

TABLE V
COST OF CAPITAL UNDER VARIOUS RECOVERY METHODS

CAPITAL COST RECOVERY SYSTEM		INFLATION = 5% REAL DISCOUNT RATE = 4%[2]	INFLATION = 8% REAL DISCOUNT RATE = 5%	Change in Cost of Capital Compared to Current Law[2]
ACRS-ITC 3 YEAR	(Present Law)	1.00	1.03	-
ACRS-ITC 5 YEAR	(Present Law)	0.99	1.04	-
ACRS 18 YEAR	(Present Law)	1.36	1.44	-
NCRS 4 YEAR	(Kemp-Kasten)	1.01	1.02	+ 1
NCRS 6 YEAR	(Kemp-Kasten)	1.01	1.04	+ 2
NCRS 25 YEAR	(Kemp-Kasten)	1.05	1.15	-23
SCRS 6 YEAR	(Bradley-Gephardt)	1.05	1.07	+ 5
SCRS 18 YEAR	(Bradley-Gephardt)	1.15	1.18	+16
SCRS 40 YEAR	(Bradley-Gephardt)	1.24	1.27	- 9
RCRS 5 YEAR	(Treasury)	1.02	1.03	+ 2
RCRS 17 YEAR	(Treasury)	1.08	1.09	+ 9
RCRS 63 YEAR	(Treasury)	1.20	1.22	-12
CCRS 4 YEAR	(Reagan)	1.01	1.02	+ 1
CCRS 7 YEAR	(Reagan)	1.05	1.06	+ 6
CCRS 28 YEAR	(Reagan)	1.20	1.23	-12
EXPENSING		1.00	1.00	-

As Table V shows, the Administration's proposed capital cost recovery system, CCRS, would substantially raise the cost of capital for equipment. Increased capital costs will reduce investment and harm economic growth. Table VI reflects three estimates of the magnitude of the decline in investment if the President's proposal is enacted.

TABLE VI

CCRS IMPACT ON REAL INVESTMENT IN PRODUCER'S DURABLE EQUIPMENT
(Percentage Difference)

MODEL	1986	1987	1988	1989	1990
DRI	+0.3	-1.5	-1.9	-1.9	-1.4
Washington U.	-4.1	-5.1	-5.2	-4.8	-3.8
Chase	-4.8	-1.0	-0.6	-1.4	-2.6

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[2] These numbers utilize Treasury's assumptions of 5 percent inflation and a 4 percent real discount rate.

The Administration's proposal may result in billions of dollars of lost investment. Without this investment, the economy will grow more slowly than it otherwise could. The Chamber strongly urges the Congress to avoid raising the cost of capital by retaining an adequate cost recovery system.

3. Windfall Tax on Excess Depreciation

The Chamber is extremely concerned about the economic effects of the Administration proposal to recapture "excess" depreciation with a windfall tax. The Administration argues that taxpayers who have benefitted from accelerated depreciation deductions would experience a windfall gain from the reduction of the corporate tax rate from 46 percent to 33 percent. The purported effect of this windfall tax would be to tax income earned from investments made between 1980 and 1985 at a 46 percent rate and tax only income earned from investments made after 1985 at a 33 percent rate.

Some windfall gains do accrue to some taxpayers because of the rate reduction from 46 percent to 33 percent. The President's proposal, however, contains many changes which could offset any windfall gains from the rate reduction and does not take into account windfall losses.

Firms engaged primarily in tax leasing will suffer from repeal of the investment tax credit. They may appear to have a windfall gain due to the accelerated depreciation on old property. But it is difficult to argue that such companies have an overall windfall gain considering the negative effects caused by other provisions in the proposal.

Owners of real property, such as shopping centers and apartment buildings, may not fare well under the Administration's proposal. They may be assessed a windfall gain due to accelerated depreciation on their buildings, while, at the same time, lengthened depreciation schedules and tighter "at risk" rules with respect to future owners may reduce the value of their buildings substantially.

Additional problems occur for those with net operating losses (NOLs). NOLs, which under current law would be worth 46 cents on the dollar, would under the Administration's plan only be worth 33 cents. Perhaps some form of compensation should be adopted for such a reduction in value.

No consideration is made under the proposal for losses due to the repeal of capital gains treatment for depreciable property and section 1231 property. It is not fair for the Administration to apply the windfall gains tax only to capital investment without some compensation for the windfall losses brought about by other provisions in the reform proposal.

The "windfall tax on gains" approach is philosophically inconsistent with previous tax policy practice. Windfall taxes have not been imposed on previous individual or corporate rate reductions. When transitions were made from old to new tax treatment of the insurance and foreign sales corporation areas, windfall taxes were not imposed on prior benefits.

The Chamber believes the windfall tax on excess depreciation will have detrimental effects on the economy. Cashflow problems will result from windfall tax payments by those companies with older investments, leaving less capital available for new investments. Reduced new investment will cause a business slowdown, especially during the three year period when the windfall tax provision is in effect.

Considering that the cost of capital will be higher as the result of other changes in the proposal, the addition of the windfall tax is an excessively unfair burden on capital investment. If continued high economic growth is the goal of this Administration, the windfall tax on excess depreciation presents a serious flaw in its philosophy, and a defect in its plan for a positive reform of the tax system.

B. The Effect of Reduced Marginal Tax Rates

The marginal tax rate is the rate of tax a taxpayer will pay on the next dollar he earns. A taxpayer's average or effective tax rate, in contrast, is the sum of taxes he pays divided by his total income. The economically more relevant tax rate is the marginal tax rate. When making the economic decision whether to work an extra hour, a taxpayer is concerned with the degree to which the extra income will be taxed. He will not concern himself with how much tax he paid on his first $1,000.

As marginal tax rates increase, so do the disincentive effects of taxation. A tax on work (employment income) makes work less attractive relative to leisure and many people will choose to work less. In economics jargon, they will substitute towards leisure because the tax raises the price of work relative to leisure.

Similarly, taxes on savings (investment income) raise the price of savings relative to consumption and cause people to substitute towards present consumption. The price of consuming now is the amount of investment income foregone by the consumer (i.e., interest the money spent could have earned if deposited in the bank instead). A tax on investment income reduces the amount of after-tax income foregone and consequently makes present consumption relatively more attractive. Confiscatory rates of tax on investment income, for example, will usually cause consumption of luxury goods to climb. An example will help to explain the reason for this substitution.

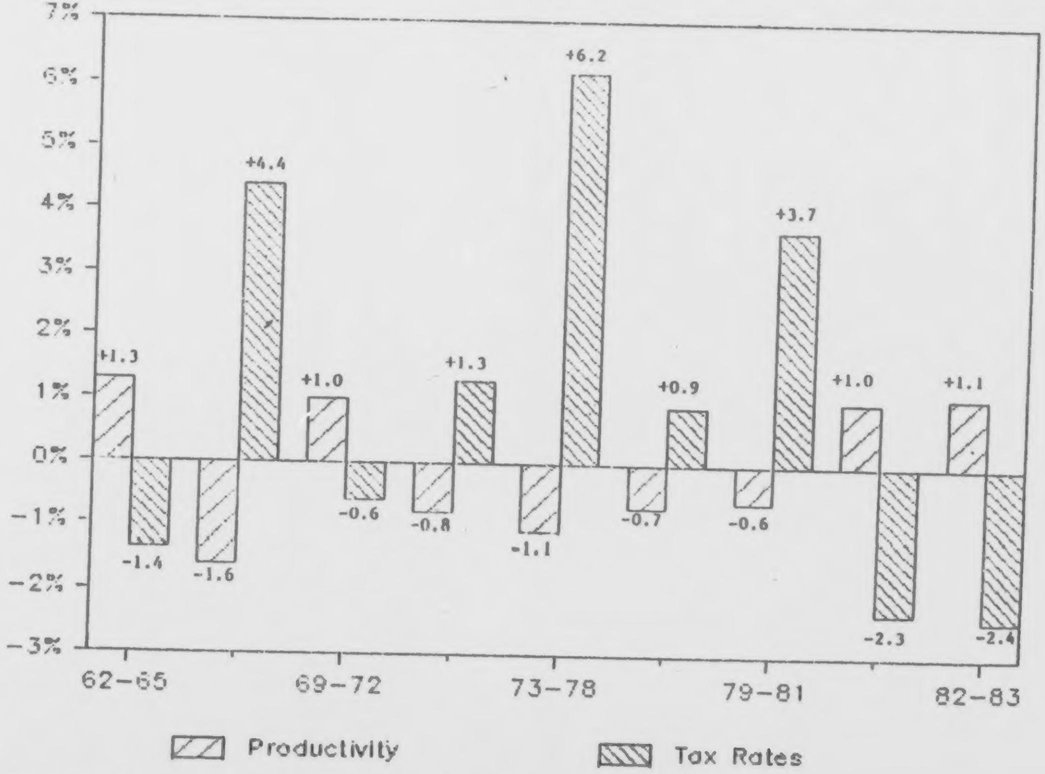
Suppose a taxpayer in a 91 percent tax bracket (which existed in the U.S. for two decades) were contemplating the purchase of a very expensive car. The purchase of a $100,000 automobile would cost its owner $10,000 annually in foregone investment income if interest rates were 10 percent. After taxes, however, the cost of owning the car would be reduced to $900. The taxpayer would only be foregoing $900 in investment income after the 91 percent tax was imposed.

The tax would reduce the after-tax price of consumption relative to investment by 91 percent. The advantage of investing and the cost of consuming would decline dramatically. Consequently, many taxpayers will choose to consume rather than invest. High tax rates reduce savings and investment.

Reduced tax rates reduce the tax distortions in consumption/savings and labor/leisure tradeoffs. This enhances the productivity of the economy. Chart 3 illustrates this inverse relationship between tax rates and productivity.

Chart 3

Changes in Tax Rates and Productivity



Source: Robert Genetski, "The Impact of Marginal Tax Rates on Productivity Performance", April 13, 1984.

In summary, tax rates and the tax base are inversely proportional. The tax base will be its largest if it is not taxed and will virtually disappear if it is subject to tax rates approaching 100 percent. In other words, higher tax rates cause reduced tax bases.

A necessary corollary of this relationship is that the government will raise progressively smaller amounts of revenue for each incremental tax rate increase. Each additional tax rate increase will accentuate the disincentive to work, save or invest.

1. The Effect of ERTA Individual Tax Rate Reductions

ERTA led to at least a 25 percent reduction of marginal tax rates for everyone and about a 7.5 percent reduction in the average person's tax liabilities. Single taxpayers making $41,500 or more and married taxpayers making more than $60,000, however, saw their rates reduced from as high as 70 percent to 50 percent, or as much as 29 percent. The details of the tax cut are set forth in Table VII.

TABLE VII

TAX RATES UNDER ERTA 1981-1984

Taxable Income (000s) (Joint Return)	1980	1981[3]	1982	1983	1984
0-3,400	0	0	0	0	0
3,400-5,500	14	13	12	11	11
5,500-7,600	16	15	14	13	12
7,600-11,900	18	17	16	15	14
11,900-16,000	21	20	19	17	16
16,000-20,200	24	23	22	19	18
20,200-24,600	28	27	25	23	22
24,600-29,900	32	30	29	26	25
29,900-35,200	37	35	33	30	28
35,200-45,800	43	41	39	35	33
45,800-60,000	49	47	44	40	38
60,000-85,600	54	50	49	48	42
85,600-109,400	59	50	50	48	45
109,400-162,400	64	50	50	50	49
162,400-215,400	68	50	50	50	50
215,400 and above	70	50	50	50	50

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[3] Late in 1981, a 1.25% credit became effective. The chart reflects the tax rate equivalent to the credit.

Proponents of these tax cuts argued that the tax cut would encourage more work, savings and investment and would lure the rich out of tax shelters and into taxable investments. In the long run, the tax cuts, by increasing the return to capital and labor, could also lead to robust economic growth, an even greater expansion of the tax base and more economic benefits for everyone.

Static revenue estimates, such as those of the CBO shown below, showed the ERTA tax cuts as losing billions of dollars in revenue, especially among upper income taxpayers.

TABLE VIII

CONGRESSIONAL BUDGET OFFICE ESTIMATES OF
TAX CHANGES RESULTING FROM ERTA AND TEFRA BY INCOME CATEGORY
($ billions)

		Household Income				
Calendar Year	All Households	Less Than $10,000	$10,000 20,000	$20,000- 40,000	$40,000- 80,000	$80,000 and over
1982	- 37.8	-0.1	-1.0	-13.6	-16.0	- 7.1
1983	- 68.0	-0.1	-4.9	-25.1	-27.8	-10.0
1984	- 93.6	-0.4	-7.3	-35.0	-38.8	-12.1
1985	-115.9	-0.9	-9.8	-44.1	-47.9	-13.3

Source: Congressional Budget Office. Based on CBO economic projections of February 1983.

The results for 1982 and 1983 are now officially in. They show emphatically that incentives do matter. The percentage of taxes paid by the rich has increased while the percent paid by the poor has actually fallen.

Tables IX and X below illustrate the supply-side effects of the first year of the tax reductions. Although their tax rates were reduced from 70 percent to 50 percent, those earning over $1 million paid 37 percent more taxes in 1982, a recession year, than in 1981. Similarly, those earning between $500,000 and $1 million annually paid 25 percent more taxes in 1982 than in 1981. By 1983, those earning over $1 million were paying 102 percent more taxes. Those earning between $500 thousand and $1 million paid 47 percent more.

Equally as fascinating is the fact that the rich paid a larger share of the total tax burden after the Economic Recovery Tax Act than before. ERTA, despite all of the misguided criticism directed toward it, made the tax system more progressive. Between 1981 and 1982 the tax burden of those earning over $1 million increased about 40 percent (from 1.7 percent to 2.4 percent of the total tax burden). The tax burden of those earning between $500,000 and $1 million increased from 1.6 percent to 2.0 percent, or 25 percent. By 1983, each group was bearing almost twice as much of the overall tax burden as they were before ERTA. In fact, only those earning below $50,000 per year actually paid a smaller portion of the total tax burden the first year after ERTA was enacted.

Chart 4 illustrates the effect of reduced tax rates on tax revenues.

Chart 4

TAXES PAID UNDER ERTA (1981—1983)

(PERCENT CHANGE)

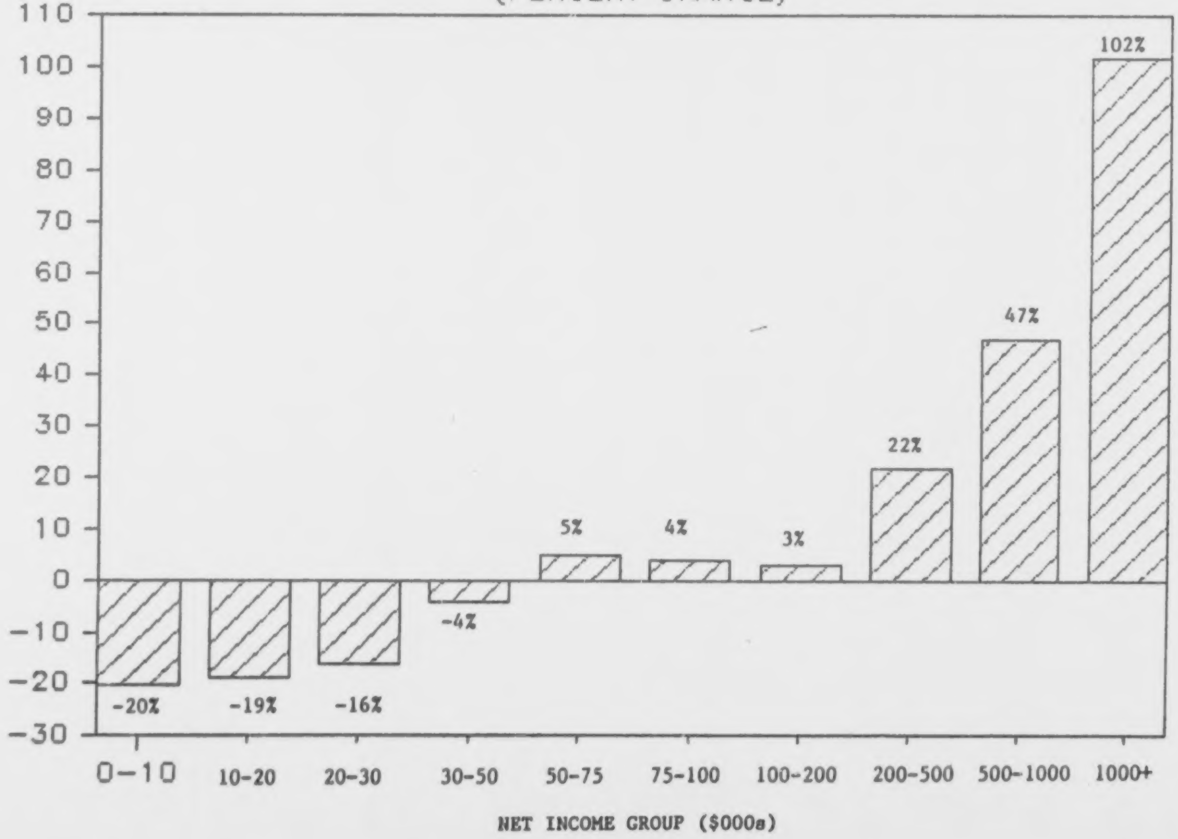

TABLE IX

TAXES PAID UNDER ERTA 1981-1983

Net Income	Revenues Collected (000,000s)			Percentage Change		
Group (000s)	1981	1982	1983	1981-1982	1982-1983	1981-1983
$0-10	$8,588	$7,627	$6,874	-11%	-10%	-20%
10-20	41,038	36,298	33,177	-12	-9	-19
20-30	57,101	53,772	47,810	-6	-11	-16
30-50	88,257	86,363	84,776	-2	-2	-4
50-75	37,504	36,807	39,460	-2	7	5
75-100	15,129	14,925	15,720	-1	5	4
100-200	22,142	22,324	22,782	1	2	3
200-500	13,174	14,399	16,129	9	12	22
500-1000	4,579	5,719	6,741	25	18	47
1000 and above	5,053	6,945	10,231	37	47	102
TOTAL	292,256	285,179	282,859	-2	-1	-3

TABLE X

TAX SHARE UNDER ERTA 1981-1983

Net Income	Percentage of Total Tax Burden		
Group (000s)	1981	1982	1983
0-10	2.9%	2.7%	2.4%
10-20	14.0	12.7	11.7
20-30	19.5	18.9	16.8
30-50	30.2	30.1	29.9
50-75	12.8	12.9	13.9
75-100	5.2	5.2	5.5
100-200	7.6	7.8	8.0
200-500	4.5	5.0	5.7
500-1000	1.6	2.0	2.4
1000 and above	1.7	2.4	3.6
TOTAL	100.0	100.0	100.0

These statistics came under sustained attack from some economists who scurried to explain them away as reflecting only the strong stockmarket or "gaming" of the tax system by wealthy taxpayers. Gaming is a term used to describe taxpayers' decisions, for example, to realize capital gains in 1982 rather than 1981 since 1982 tax rates were reduced.

The most recent statistics belie the gaming thesis. Gaming is a one year phenomenon that necessarily reduces the following year's taxable income (1983 in this case). The share of the overall tax burden paid by the wealthy has continued to increase since 1983.

Despite the howls of righteous indignation from the self-proclaimed advocates for the poor, the simple facts illustrate that the 1981 Reagan tax program has increased the burden borne by the well-to-do and reduced the proportion of the republic's taxes paid by the poor.

As the supply-siders predicted, the tax rate reductions for taxpayers subject to high marginal tax rates paid for themselves and caused a dramatic improvement in the economy.

As demonstrated below, the evidence from previous rate reductions is overwhelming that marginal tax rates above 35 percent are counterproductive. They cost the government revenue rather than increase it. Currently, slightly more than two-fifths of the total individual tax revenue comes from taxpayers that are in tax brackets higher than 35 percent. Even if it assumed, contrary to the historical evidence, that there will be no revenue increase resulting from the reduction in maximum rate from 50 percent to 35 percent, the revenue loss from the rate changes will be no higher than $156.4 billion versus the Treasury static revenue estimate of $260.6 billion (1986-1990).

Our estimate also assumes that there are no incentive effects from rate reduction below the 35 percent marginal tax rate. Obviously, if more realistic assumptions were used, the revenue loss would be even lower.

TABLE XI

REVENUE LOSS FROM THE ADMINISTRATION PROPOSED INDIVIDUAL RATE REDUCTION

Fiscal Years

	1986	1987	1988	1989	1990	Total
Treasury Estimate (Static)	-11.1	-49.5	-60.6	-66.7	-72.7	-260.6
Chamber of Commerce (Estimate[4])	- 6.7	-29.7	-36.4	-40.0	-43.6	-156.4
Difference	+ 4.4	+19.8	+24.2	+26.7	+29.1	+104.2

2. Earlier Supply-Side Experiments

Skeptics continue, despite the evidence, to attack ERTA as being both unfair and a "massive revenue drain". Most disappointing is the fact that simple denial of the record continues to be received as reasoned argument in some quarters. If one is willing to look objectively at the facts, ERTA has been an unqualified success. It has been "fair" -- if that means that the wealthy are paying more. It provided a 25 percent across-the-board individual tax cut and four years later individual income tax revenues are 15 percent higher ($329.7 billion in fiscal year 1985 versus $285.9 billion in fiscal year 1981). And finally, it has reduced the disincentives to work, save and invest so dramatically that the economy has grown at almost unequaled rates.

Proponents of reduced tax rates are not limited to arguing the merits of ERTA, however. Other equally compelling evidence exists to prove the thesis that high marginal tax rates have a devastating effect on the economy and can become literally counterproductive. The Kennedy tax cuts of 1963 to 1965 tell the same story. So do the Mellon tax cuts during the 1920s. Finally, the facts surrounding the reduction in the rate at which capital gains are taxed illustrate that reduced tax rates often literally increase tax revenues. Table XII compares marginal tax rates under the 1954 Internal Revenue Code, under the Kennedy proposal and as enacted by the 1964 act.

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[4] Using conservative partially dynamic estimates as explained above.

TABLE XII

TAX RATES 1954-1964

Taxable Income ($ 000) (Joint Return)	1954 Act	1964 Act
0-1	20	14
1-2	20	15
2-3	20	16
3-4	20	17
4-8	22	19
8-12	26	22
12-16	30	25
16-20	34	28
20-24	38	32
24-28	43	36
28-32	47	39
32-36	50	42
36-40	53	45
40-44	56	48
44-52	59	50
52-64	62	53
64-76	65	55
76-88	69	58
88-100	72	60
100-120	75	62
120-140	78	64
140-160	81	66
160-180	84	68
180-200	87	69
200-300	89	70
300-400	90	70
400 and above	91	70

In January, 1963, President Kennedy proposed reducing individual marginal income tax rates from the 20-91 percent range that had prevailed since 1946 to 14-65 percent. In addition, President Kennedy proposed reducing the corporate tax rate from 52 to 47 percent. In February 1964, the Congress enacted the Revenue Act of 1964 which reduced rates to the 14-70 percent range.

These marginal tax rate reductions caused total federal individual income tax revenues to increase and made the tax system more progressive. Those earning over $1 million paid 147 percent more taxes after the marginal rate cut and they paid a 232 percent larger share of the total tax burden. Those earning less than $10,000, however, paid 28 percent fewer taxes and their share of the tax burden declined from 39 percent of the total to 25.7 percent. The effects, set forth in Tables XIII and XIV, are analogous to those recently experienced after ERTA was enacted.

The effects are much more explosive because pre-Kennedy tax rates of up to 91% were, by any standard, confiscatory. The Kennedy reduction in the maximum tax rate from 91 percent to 70 percent increased marginal after-tax income by as much as 233 percent while the ERTA reduction from 70 to 50 percent increased marginal after-tax income only 67 percent.

TABLE XIII
TAXES PAID AFTER KENNEDY TAX CUTS

Net Income	Revenues Collected (000,000s)			Percentage Change		
Group (000s)	1963	1964	1965	1963-1964	1964-1965	1963-1965
$0-10	$2,624	$2,167	$1,883	-17%	-13%	-28%
10-20	1,371	1,742	1,722	27	1	26
20-50	1,380	1,391	1,555	1	12	13
50-100	638	689	846	8	23	33
100-500	492	625	816	27	31	66
500-1000	87	124	179	43	45	106
1000 and above	131	185	323	42	74	147
TOTAL	6,723	6,923	7,325	3	6	9

TABLE XIV

TAX SHARE UNDER KENNEDY TAX CUTS 1963-1965

Net Income	Percentage of Total Tax Burden		
Group (000s)	1963	1964	1965
$0-10	39.0%	31.3%	25.7%
10-20	20.4	25.2	23.5
20-50	20.5	20.1	21.2
50-100	9.5	10.0	11.6
100-500	7.3	9.0	11.1
500-1000	1.3	1.8	2.4
1000 and above	1.9	2.7	4.4

The other major marginal tax rate reduction was after World War I under Presidents Harding and Coolidge during Andrew Mellon's tenure as Secretary of the Treasury. Table XV sets forth the results of that tax cut. Top tax rates were reduced from 73 percent to 25 percent over four years. Despite such a dramatic rate reduction, federal revenues actually increased by 2 percent. Furthermore, as under ERTA and the Kennedy tax cuts, the proportion of the total tax burden borne by the wealthy increased.

TABLE XV
FEDERAL INCOME TAX REVENUES 1921-1925

Net income class (000s)	1921	1922	1923	1924	1925	Change 1921-25
$0-5	$ 92,791	$ 95,591	$ 81,047	$ 47,650	$ 13,909	-85%
5-10	68,871	70,387	55,480	28,627	19,150	-72
10-15	51,807	49,147	41,899	26,344	22,419	-57
15-20	41,183	40,430	33,400	25,899	25,090	-39
20-50	146,808	159,696	132,166	135,187	147,353	0
50-100	115,712	144,092	108,879	136,636	147,843	+28
100-500	145,685	213,635	149,493	213,930	238,252	+64
500-1,000	25,112	38,560	25,499	42,586	53,674	+114
1,000+	31,419	49,517	35,789	47,207	66,867	+113
Total percent	$719,387	$861,057	$663,652	$704,265	$734,555	+ 2
Maximum marginal income tax rate	73%	58%	58%[5]	46%	25%	+28%

Even partisans of big government should favor the Reagan, Kennedy and Mellon tax rate reductions for upper income taxpayers. Those tax cuts raised more money for the government to spend. We have not examined, however, the enormous cost of high tax rates to the broader public. Both those paying taxes and those hoping to have enough income that they must pay taxes are forced to bear the burden of a stagnant economy, devoid of hope and opportunity. Low rates of economic growth have been thrust upon the American economy by those who would rather assuage their conscience by angry rhetoric and misguided attempts to punish the rich when America could have an economy sufficiently dynamic to improve everyone's living standard.

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[5] The tax for 1923, computed at 1922 marginal tax rates, was reduced 25 percent by credit or refund under the Revenue Act of 1924.

3. Indexing Must Be Retained

Beginning this year, the personal exemption and tax rate brackets will increase each year to compensate for increases in the cost of living as measured by the Consumer Price Index (CPI). This provision is most important to lower and middle income taxpayers; wealthy taxpayers are already in the top bracket and, therefore, will remain subject to the same top marginal rate whether the tax code is indexed or not.

Tax indexing is a major step toward assuring honesty and integrity in the tax policy process. It will prevent continued unlegislated increases in real individual tax liabilities that result entirely from the effects of inflation on the tax system. If tax indexing were repealed, individual and business taxpayers at the lower income levels would continue to be taxed at higher and higher rates. Furthermore, inflation would lessen the value of the personal exemption and zero bracket amount, which are relatively more important to lower income persons.

As noted above, the relative tax burden on the wealthy has increased over the past several years. This is partially because we have had de facto indexing. The 25 percent cut in marginal rates has benefitted lower-income taxpayers disproportionately over the past several years; middle-income taxpayers received a reduction in rates each year -- helping them to compensate for bracket creep -- while the highest-income taxpayers remained subject to the highest marginal rates. The rate cuts helped lower-income taxpayers avoid bracket creep, even though the tax code was not indexed. Inflation increased their nominal incomes, but not their real incomes, and would have forced them into ever higher tax brackets if the tax cuts had not been taking effect at the same time.

The Congressional Research Service in a January 1983 study noted that because of narrower low-income tax brackets and fixed personal exemptions, inflation disproportionately hurts lower and middle-income taxpayers. It concluded that this continual increase in their tax burden will be stopped by indexing. Instead of increasing the burden on the middle income taxpayers, it concludes that "once indexation begins this new distribution will, for all practical purposes, be 'locked in." That is certainly preferable to increasing the burden on middle-income taxpayers by continued and unlegislated bracket creep.

The Chamber supports the President's proposal to retain tax bracket indexing.

The Chamber also supports indexation of capital basis and inventories. Without indexing, purely phantom inflationary gains are taxed. Often businesses with inflation adjusted losses are paying taxes on "gains" and all businesses are being overtaxed.

C. The Double Taxation of Corporate Dividends

The Chamber commends the provision in the Administration proposal providing a 10 percent deduction for dividends paid by corporations. Corporations pay taxes on their profits, and then shareholders must pay taxes again on their dividends. This double taxation of income reduces the amount of capital available for investment and is both unfair and destructive of economic growth. Double taxation of income encourages the firms to retain earnings rather than pay profits out as dividends. Thus the double taxation of corporate dividends reduces the liquidity and efficiency of capital markets. It encourages concentration of business and discourages the development of new enterprises.

Other tax reform proposals provide for some form of dividend deductibility. The Quayle bill allows for a 100 percent dividend paid deduction for new stock issues. Dividend deductibility makes owning stock more desirable, assisting start-up businesses that rely heavily on the issuance of stock to raise capital. We urge Congress to use tax reform as an opportunity to take an important step forward in the elimination of the double taxation of corporate income.

D. Capital Gains

In both 1978 and 1981 the rate at which capital gains were taxed was dramatically reduced. In 1978, capital gains tax rates were reduced from 49 percent to 28 percent. In 1981, the rate was reduced from 28 percent to 20 percent. During that period, the definition of capital gain did not appreciably change. In many important ways, the result of the capital gains tax rate reduction was the same as the broader ERTA, Kennedy and Mellon tax cuts. The rate reduction led to at least $2.5 billion more federal revenues and increased the proportion of total taxes borne by the wealthy. It also led to higher taxes on the wealthy. Table XVI shows net long-term capital gains by income class in 1978 and 1981. If we assume, as is almost certainly the case, that those with adjusted gross incomes over $500,000 are in the maximum tax bracket, then capital gains taxes paid by the wealthy were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130 percent increase in tax revenues.

TABLE XVI

NET LONG-TERM CAPITAL GAINS 1978-1981

Net Income Class ($000)	Net Long-Term Gains (in billions) 1978	1981	Percentage Change 1978-1981
0-25	$9.7	$13.2	36.1%
25-50	9.0	10.2	13.3
50-100	6.6	11.2	69.7
100-500	8.6	19.0	120.9
500 and above	3.7	14.9	302.7

In 1978, opponents of lower capital gains taxes argued that the reduction would cost the Treasury over $2 billion in revenue. Voicing Treasury's opposition to the 1978 proposal to reduce capital gains tax rates, Secretary Blumenthal asserted, "The measure would do little for capital formation on its own and would waste revenues". The facts paint a much different picture (See Table XVII). Capital gains tax revenues have steadily increased even though the maximum tax rate was cut by more than 50 percent.

TABLE XVII
TAXES PAID ON CAPITAL GAINS[6]

Year	Capital Gains (billions)	Tax Rate (percent)	Tax Revenue (billions)
1967	$13.7	25.0%	$4.1
1968	18.0	25.0	6.0
1969	14.6	42.5	5.5
1970	9.0	42.5	3.3
1971	13.1	42.5	4.3
1972	17.1	42.5	6.6
1973	16.7	42.5	5.3
1974	13.5	42.5	4.2
1975	14.1	42.5	4.5
1976	18.6	49.0	6.6
1977	20.6	49.0	6.6
1978	23.2	49.0	8.1
1979	28.4	28.0	10.9
1980	29.7	28.0	11.6
1981	30.8	20.0	12.5
1982	34.4	20.0	12.9
1983	45.1	20.0	13.9

Note: The tax rate used in the table is the effective maximum tax rate on capital gains above $50,000.

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[6] Source: Federal Taxes in Historical Perspective, Office of Economic Research, February 1982, New York Stock Exchange

The figures on tax revenues are remarkable. When the capital gains tax rate was raised in 1969, tax revenues from capital gains stood at $5.5 billion. However, even though the maximum tax rate had been doubled after 1969, tax revenues averaged only $5.3 billion per year from 1969 to 1978 (the period of high capital gains taxes). In stark contrast, after the capital gains tax rate had been sliced by nearly half in 1978, tax revenues from capital gains averaged $11.1 billion per year. This provides substantial evidence for Adam Smith's dictum that moderate taxation often provides government with more than does higher levels of taxation.

We strongly endorse further reduction in the capital gains tax rate as proposed in the President's tax reform package.

E. Tax Reform and Savings

Personal savings are responsive to the tax treatment of savings. Individual Retirement Accounts (IRAs), Keogh retirement plans, 401(k) savings plans and the tax treatment of corporate pensions all reduce the tax bias against savings in the United States. Because these provisions reduce or eliminate the tax wedge between the before and after tax return to savings, savings rates are not reduced as much as otherwise would be the case under an income tax system.

The proposal to expand IRAs by increasing the spousal IRA amount to $2,000 would improve the U.S. savings rates. However, the Administration harkened back to the November 1984 U.S. Treasury Department proposal and called for the elimination of 401(k) plans. Prohibiting these plans would deal a serious blow to a sensible and important retirement income program implemented by many employers on behalf of their employees.

Over 20 million American workers participate in 401(k) plans; nearly one-half million small businesses offer these plans to their 4.5 million employees. These plans are enormously popular and useful for ensuring adequate levels of retirement income security.

Even without total elimination, the President's May 1985 proposals for substantial restrictions are cause for concern. The Chamber believes the proposed rules regarding participation in 401(k) plans, as well as the proposed elimination of the availability of hardship withdrawals of after-tax contributions, and imposition of a 20% excise tax for pre-age 59-1/2 withdrawals, as well as a 10% excise tax for post-age 59-1/2 withdrawals deemed excessive, would all make such plans less attractive to many employers and employees.

The restrictions on withdrawals are intended to ensure that 401(k) contributions are dedicated for retirement security needs. However, the unintended result of such changes would be reduced participation in such plans by lower- and middle-income employees for whom the availability of withdrawing the savings in case of an emergency is essential to participation. It would be an ironic and unfortunate twist of fate if the very same people -- lower-paid employees -- whose interests are most sought to be served by provisions of the tax proposals find that the prescribed practices for 401(k) plans so bind their savings that they are dissuaded from participation in the programs altogether. As a result, the plans could fail the nondiscrimination participation standards or not be offered in any form.

Reducing the 401(k) contribution list to $8,000 and then further reducing that level by the amount of contributions to an Individual Retirement Account (IRA) not only will make 401(k) plans less popular but also will increase substantially the administrative burden for plan sponsors. Even if the ultimate responsibility for ensuring that combined 401(k) and IRA contributions stay below the minimum limit falls upon individuals, employers will experience enormous administrative difficulty in making projections of 401(k) contributions (which may change during a year as compensation levels change) so that their employees will not run afoul of the law. The $8,000 limit reduced by IRA contributions also would be especially troublesome for the employees of those businesses in which the 401(k) plan is the only type of retirement program offered.

However, the restrictive nature of the proposed participation and withdrawal rules could effect the elimination of these plans.

Finally, eliminating the availability of 401(k) plan participation for employees of tax-exempt organizations is illogical. If the stated purpose of the existence of 401(k) plans is to encourage savings for retirement years, the tax status of one's employer should not be the factor determining whether one may participate in such a plan. Moreover, the premise upon which 401(k) plan participation is to be denied to employees of tax-exempt organizations -- availability of Tax Sheltered Annuities and Deferred Compensation Plans -- is inaccurate. Tax Sheltered Annuities are not permitted by law for many types of tax-exempt groups, and Deferred Compensation Plans do not contain all the beneficial features of 401(k) plans.

Lower marginal tax rates, all other things being equal, will have the effect of increasing the after-tax return to savings and, therefore, increase aggregate U.S. savings.

II. Technological Advancement

The U.S. Chamber applauds the Administration's proposal for including the three-year extension of the research and development tax credit. The research and experimentation tax credit has stimulated research and development in this country since it was enacted in 1981. Extension of the credit will assist in greater technological advancement, the improvement of our ability to compete internationally, and job creation. The U.S. Chamber also supports the Administration's proposal to revise the definition of qualified research to more narrowly targeted activities.

In terms of total research and development expenditures, expressed as a percentage of GNP, the United States has led the free world since at least the late 1960s. In recent years, however, our lead has substantially narrowed. Research expenditures are a crucial element in improving our ability to compete abroad. A permanent research credit would offer the stable and predictable tax policy necessary to successfully compete internationally.

A report released in February, 1985 by the Brookings Institution and Data Resources, Inc. documents the role of industrial research in fostering economic expansion and international competitiveness. Prior to the enactment of the R & D credit, the U.S. devoted the smallest share of GNP to private research of any industrial nation. After the credit was enacted in 1981, the gap began to close.

This new report provides quantitative estimates of the economic benefits of a permanent credit. The most conservative estimate in the report shows that, upon enactment of the permanent credit, annual benefits to GNP would be $1.2 billion in 1986 and $2.9 billion in 1991. "Best case" estimates show benefits as high as $7.5 billion in 1986 and $17.7 billion in 1991.

The credit will stimulate additional research spending. Increased research and development ultimately results in increased profits, which, in turn, translates into revenues to the federal government.

Investment in research is, by nature, a long-term proposition. If we are to achieve our goals of capital formation, technological advancement, international competitiveness, and job creation, research expenditures must be conducted at high levels for many years. A stable and predictable tax policy is necessary for such expenditures to continue. Consequently we recommend making the research credit a permanent feature of the tax code.

We also recommend that the Congress retain provisions in the tax code that allow research expenditures to be expensed. Research expenses, like other expenses, should be deducted in the year incurred rather than amortized over long periods. Only expensing, as under present law, eliminates the tax bias against investment in research.

The Treasury Department recently announced that it would not support continuing the moratorium on the allocation of research and development expenditures under Treasury Regulations section 1.861-8. This Treasury regulation, enforcement of which have been suspended by a statutory moratorium since 1981, would allocate a portion of research and development expenditures incurred in the United States to foreign source income. The effect of these regulations would be to create double taxation of certain foreign income as a result of an arbitrary allocation of research expenses to that income, which might not be recognized for purposes of calculating income subject to tax under foreign law.

We understand the Treasury Department's concern with extending a moratorium in the midst of discussions on major tax reform. We believe the appropriate solution to this dilemma would be to allocate research expenses incurred in the United States to U.S. source income.

III. International Competitiveness

The Chamber is greatly concerned with the effect of tax reform on international competitiveness. There are several international tax provisions which will have a negative impact on the ability of U.S. companies to compete with our foreign trading partners.

U.S. business presently faces difficult obstacles in competing with foreign firms. These obstacles are due to the high value of the dollar, tariff and non-tariff barriers to U.S. firms entering overseas markets, and foreign government subsidization of industry. We recognize that the solution to our trade problem is not the subject of today's hearing. However, there are a number of provisions in the Administration's tax reform proposal which would further exacerbate the problem of U.S. competitiveness in world markets.

As we have already discussed, proposals to increase the cost of capital will result in the need to raise prices on U.S. products and thus cause them to be less competitive with foreign made goods. This increase in the cost of capital could also cause U.S. firms to fail to invest in more technologically advanced processes and on that basis make U.S. produced goods uncompetitive with foreign produced goods. Moreover, there is strong reason to believe that inadequate capital cost recovery allowances could cause U.S. businesses to locate their manufacturing plants abroad where the tax treatment of investment is more favorable. The Congress should not exacerbate the flight of U.S. manufacturing facilities by replacing ACRS with inadequate capital cost recovery allowances.

In addition to the capital formation provisions, several of the international tax provisions of the proposal will affect the ability of U.S. firms to compete.

A. Foreign Tax Credit

The Administration has proposed calculating the foreign tax credit limitation on a per country basis, rather than under the overall method currently in use. The U.S. rules for calculating the foreign tax credit are designed not only to prevent double taxation of foreign source income but also to limit the credit to U.S. tax imposed on income earned and taxed overseas. The credit is designed so that it does not reduce U.S. tax on income earned from operations in the United States. This is true whether or not an overall limitation or a per country limitation is used.

The overall limitation permits averaging of taxes paid in high-tax countries with those paid in low tax countries. Although Treasury may regard averaging as a potential abuse, averaging of bona fide foreign taxes imposed on foreign source income is a proper attribute of a foreign tax credit. This is true because within the context of global business operations averaging is a realistic way of dealing with the complexities of international trade where business is ordinarily conducted on an integrated rather than a per country basis. Averaging mitigates the mismatching that is often caused by the different rules that exist between countries for determining the tax base and the timing of income and deductions. Most countries that avoid international double taxation either use an overall limitation (as does Japan), exempt direct investment income, or use a per country limitation that permits a form of averaging and bears no resemblance to the more exacting per country method proposed by the Administration. (See Appendix, Survey of Taxation of Foreign Source Income by Certain Major Industrial Countries) Thus, adoption of a per country limitation, as proposed by the Administration, would cause U.S. companies to be subject to greater double taxation of foreign income than are their foreign competitors.

Companies do not organize strictly on a country-by-country basis. A German manufacturing subsidiary of a U.S. company may well develop technology that it licenses to a Dutch or Japanese enterprise and will sell its products throughout Europe, Africa, and perhaps elsewhere and may do so through branches or sub-subsidiaries. The averaging effect of the overall method is consistent with the approach normally taken by U.S. businesses in making investments abroad -- to serve broad geographic markets which may involve production, transportation and marketing facilities in several different countries.

As is stated above, the Administration's per country proposal would put U.S. businesses at a competitive disadvantage when compared to the foreign tax credit rules used by our trading partners. Our major trade rival, Japan, has an overall limitation. Additionally, Japan has a network of tax sparing treaties, which allow Japanese firms to credit the tax foregone by the host country against tax liability to Japan. When combined with the use of the overall limitation, this provides Japanese companies a credit for taxes that were never paid. The Japanese system provides Japanese business with a tax advantage over the United States even under current law, which would be greatly exacerbated if the Administration's per country proposal were adopted.

Canada, France and Germany employ a mixed system primarily relying upon exemption (under treaty or by statute) and permitting foreign tax credits under the per country method where exemption does not apply. However, in those countries using a per country method, including the United Kingdom, a form of averaging is permitted through the use of third country holding companies.

Thus, the per country proposal would lead to an increase in the overall effective tax rate on foreign source income of U.S. business and decrease U.S. competitiveness. The following example shows the differences in the effect of a per country limitation and an overall limitation on a U.S. company.

Assume a U.S. company with subsidiaries in Canada and Chile derives the following income and is subject to the following taxes:

	Per-Country Limitation	Overall Limitation
Gross interest income earned in Canada	$100	$100
Gross interest income earned in Chile	100	100
Total foreign source income	200	200

15% Canadian withholding tax (applied on gross income as prescribed by U.S./Canada tax treaty)	15	15
No Chilean withholding tax	0	0
Total foreign tax	15	15
U.S. expenses allocated and aportioned to foreign income under Reg. Sec. 1.861-8		
Canada	90	
Chile	60	
Total Expenses	150	
Canadian-sourced net income	10	
Chilean-sourced net income	40	
Foreign-sourced net income	50	
Foreign Tax Credit (FTC) Limitation (46% of net foreign income equals pre-FTC U.S. tax liability)		23
Canadian	4.60	
Chilean	18.40	
FTC		15
Canada	4.60	
Chile	0	
Excess FTC	10.40 (Canadian)	0
U.S. tax paid	18.40	8
Foreign tax paid	15.00	15
Total tax paid	33.40	23
Effective tax rate on foreign source income	66.8%	46%

As the foregoing example illustrates, the overall foreign tax credit limitation, through its averaging mechanism permits the U.S. taxpayer to pay an overall rate of tax equivalent to 46 percent. A per country limitation causes excess foreign tax credits as a result of our rules for allocating and apportioning U.S. expenses to foreign source income; thus, $10 of Canadian source income is subject to a $15 Canadian tax and thereby an effective tax rate of 66.8 percent on overall foreign income.

Excessive taxation under the per country limitation is inevitable. The United States determines the foreign tax credit limitation by computing net foreign source income (gross income less deductions). The United States has negotiated tax treaties permitting foreign withholding taxes on gross income (income without reduction by expenses). Indeed, in some important instances, such as Germany, the Treasury has failed to obtain treaties reducing excessively high foreign corporate and withholding taxes on substantial amounts of U.S. foreign investment. This discrepancy can cause inequities even under the overall limitation, but the overall limitation mitigates the harm because foreign tax credits generated in one country may be taken against income generated in another country (one in which, perhaps, little if any foreign tax is paid). Under the per country method, the foreign withholding tax (based on gross income) may well exceed 100 percent of the net income determined after applying Reg. Sec. 1.861-8.[7]

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[7] Although the per country limitation has been required in the United States in the past, that limitation was prior to effective implementation and audit of the allocation and apportionment rules under sections 861-863. Prior to the promulgation of the revised Reg. Sec. 1.861-8 regulations both the foreign tax credit limitation and most foreign withholding taxes generally were computed on gross income so many of the inequities which would arise today under the per country limit did not result.

The Treasury per country proposal is based on the premise that the overall limitation leads U.S. multinational companies to distort their worldwide investment decisions for purely tax motivated reasons, giving many taxpayers a tax-motivated incentive to invest abroad rather than in the United States. This is based on an assumption that the averaging permitted by the overall limitation gives taxpayers with operations in high-tax countries an incentive to invest in low tax countries in order to utilize the excess foreign tax credits generated from investments in a high-tax country.[8]

Decisions on investment in manufacturing and production facilities are generally driven by considerations much broader than tax matters. Access to market, transportation costs, work force, location of raw materials, and government regulations are all important factors in the basic investment decision. For example, pharmaceutical manufacturers may be required to locate in a particular country in order to meet local law requirements relating to the distribution and sale of finished pharmaceutical products. Less developed countries may require local content for products sold in their market. Taxes will be a factor in the ultimate analysis of whether an activity is economically feasible. Data on U.S. direct investment abroad does not suggest a disproportionate or even very significant amount of manufacturing investment in countries with very low tax rates or tax holidays. The Department of Commerce data for 1982 which is the most recent data available, showed that total U.S. direct investment abroad for 1982 was $221.5 billion for all industries. Manufacturing investment was $90.5 billion. Of the manufacturing investment, approximately 81 percent was in Western Europe, Canada and South America. The aggregate manufacturing investment in the tax holiday countriesof Hong Kong, Ireland, Singapore, South Korea and Taiwan was approximately 4.6 percent of total foreign manufacturing investment and approximately 1.9 percent of total foreign direct investment.[9]

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[8] Under the foreign tax credit provisions, U.S. taxpayers are provided a credit against U.S. income tax liability on foreign source income for foreign taxes paid. This tax credit, however, is limited to the U.S. corporate income tax rate (currently 46 percent). Thus, when a foreign jurisdiction imposes taxes at a higher rate, excess credits are generated.

To the extent that excess foreign tax credits provide an incentive to move the location of financial assets to generate low taxed foreign source income, U.S. tax laws have been amended to limit such artificial activity. The overall limitation is applied separately with respect to certain classes of income, such as interest income and certain oil income where Congress saw a need for special rules to prevent shifting of income for tax reasons. If further refinements are necessary, they should be made with regard to specifically identified problems and without the extreme solution of abandoning the overall method. The Chamber would be happy to meet with members of this Committee and staff to arrive at such a solution to these problems.

Treasury's per country proposal would generally place U.S. business operating abroad at a competitive disadvantage compared to their foreign counterparts operating abroad. Foreign investment and operations by U.S.

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[9] U.S. Department of Commerce, Survey of Current Business, August 1984, p.28.

businesses provide significant benefit to the U.S. economy in the form of jobs, increased exports, trade balance and tax revenue. At a time when the President's Commission on Industrial Competitiveness has called for the elimination of practices that are impeding the ability of U.S. companies to keep pace with the "new reality of global competition,"[10] Treasury proposes to introduce a new barrier to the penetration of foreign markets -- the per country limitation.

Where U.S. plants are established in a low-tax foreign country, that decision is generally not primarily a strategy to eliminate excess foreign tax credits, but rather to effectively compete with foreigners. Location of plants in the various low-tax countries is predominantly a defensive investment -- a means of competing with foreign-based companies on a "level playing field." For example, if a foreign-based company builds a plant to manufacture products for the European Common Market, it typically would favor a European country with a low-tax rate or a favorable tax holiday period, assuming it was otherwise a practical location within that market. If a U.S.-based company desires to compete in marketing a particular product in Europe, plant location in a country such as Ireland may be considered as a feasible option to reduce the burden of local taxes. The tax incentives offered by Ireland and other low-tax foreign countries would, however, be effectively denied to U.S. investors under a per-country limitation, and foreign competitors would reap the benefits by taking over the market share. This would not only have an adverse effect on the earnings of U.S. companies, but it would also damage the U.S. economy.

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[10] The Report of the President's Commission on Industrial Competitiveness, Global Competition; the New Reality (January 1985).

B. Sourcing Rule Changes

Our tax laws define the source, foreign or U.S., of income and expenses for the purpose of defining the scope of U.S. taxation and where primary jurisdiction for taxation of U.S. citizens is conceded to a foreign country because income is deemed to be earned in that country. The source of income and expenses of U.S. taxpayers becomes part of the formula for determining the amount of the foreign tax credit allowed to U.S. taxpayers for taxes paid to foreign jurisdictions because the credit is allowed only to the extent foreign taxes are paid on "foreign source" income.

1. Export Sales

The proposed changes with regard to the sourcing rules for sales will result in a tax increase for U.S. exporters. Under current law, income from sales of personal property is considered to be earned at the place of sale, as determined by passage of title (i.e., contemporaneous passage of the significant incidents of ownership). The Administration's proposal would generally consider such income to be earned in the country of the taxpayer's residence unless the seller maintains a fixed place of business outside of its country of residence and that fixed place of business participates materially in the sale generating the income. However, all sales to a taxpayer's foreign subsidiaries would be sourced at the seller's residence, and a fixed place of business maintained by an independent distributor would not be attributed to the seller for purposes of this source rule.

The effect of this proposal will be to directly increase the tax earned on income from export sales. Last year the Administration proposed and Congress enacted the Foreign Sales Corporation provisions because they recognized the importance of encouraging U.S. exports, given the current value of the dollar and the U.S. trade deficit. Yet, the proposals to change the source of income rules as applied to export transactions substantially undercut that effort without any analysis of the impact such a change might have on U.S. trade. Indeed, the obvious effect of this proposal would be to either (1) increase the tax on U.S. exports, or (2) force exporters to establish more fixed places of business outside of the United States. We query whether our national policy should be to do either.

2. Allocation of Interest Expense

Under present law, interest expense incurred by members of a related group of corporations is allocated and apportioned between domestic and foreign sources on a separate company basis. The Administration's proposal would require that the interest expense incurred by one or more members of a related group of corporations be allocated to all members of the group. The Administration has proposed this change because of a concern that taxpayers would be able to manipulate the location of borrowings within a consolidated group of corporations in order to maximize tax advantages.

Borrowings of subsidiaries are made for solid business, not tax-motivated reasons. Where a subsidiary is a regulated common carrier, the tariff, which includes an interest element in the rate schedule, will be set by the Interstate Commerce Commission. Captive domestic finance companies doing business with third parties are self-sustaining business operations supported by their own borrowings. It is only on an arbitrary basis that interest expense incurred by such a finance company would be allocated to income from the foreign manufacturing subsidiary of the U.S. parent which may finance its own operations. Also, debt may be incurred by a subsidiary in order to limit liability, where the creditor's only recourse is against the subsidiary and not against the parent. This situation may be of particular concern where a subsidiary is located in politically unstable countries. Finally, a loan may be structured whereby the revenues earned from the financial asset will be the security on the debt.

The proposed rule will favor a foreign controlled U.S. group by permitting greater interest expense allocations to U.S. income where there is a foreign parent than in the case of a chain of ownership of U.S. and foreign corporations controlled by a U.S. parent. The proposal would almost certainly result in overallocation of expense to foreign source income of U.S. companies.

The inequities of the proposal can be illustrated by the following example:

> Example: Corp. A is a U.S. corporation engaged in manufacturing operations in the United States. Corp. A also earns fees from the licensing of patents to its subsidiaries. Corp. B is a wholly owned domestic subsidiary of Corp. A and is engaged in manufacturing operations primarily in the United States, with some operations located in Canada. Corp. C is a wholly owned French subsidiary of Corp. A and is engaged in manufacturing operations in France. Corp. D is a wholly owned German subsidiary of Corp. A and is engaged in manufacturing operations in Germany. During the tax year in question, Corp. B borrows funds from a U.S. bank for use in its U.S. business operations and incurs interest

> expenses on the loan. Also, Corp. C borrows funds from a French bank for use in its business operations and incurs interest expense on the loan.
>
> Under the present rules, Corp. B's interest expense (although incurred to finance its domestic operations) would be apportioned between Corp. B's U.S. and Canadian source income. This apportionment would generally be done on the basis of Corp. B's assets located in the United States and Canada. Alternatively, an election to use the "optional gross income" method to apportion interest expense would take into account gross income derived by Corp. B from U.S. and Canadian sources.
>
> Under the proposed combined group method, Corp. B's interest expense would have to be apportioned (in part) to Corp A's income. In addition, since Corp. A's assets include its stock ownership in Corp. C and Corp. D, Corp. B's interest expense would have to be apportioned (in part) to the income of those two foreign corporations. It should be specifically noted here that, in applying the interest allocation regulations on a combined group basis, Corp. B's interest expense is effectively considered to finance (in part) the manufacturing operations in France -- even though the French affiliate is financing its own operations through local borrowings.

The net effect of the proposal is a double charge of interest to foreign affiliates whose own borrowings would be entirely disregarded under the regularly prescribed asset allocation method based upon the taxpayer's tax basis in its assets.

The proposal to spread interest expense throughout a related group of corporations without regard to economic reality and without regard to the computation of foreign income on which foreign taxes are actually levied is unwarranted. This proposal would place U.S. owned companies at a competitive disadvantage to foreign owned companies operating in the United States, which would not be subject to these rules.

IV. Job Creation

This country has made unprecendented gains in creating new jobs in the last few years. Since December 1982, when the economic recovery began, American business has created nearly 8 million jobs. This surpasses the record of any other industrial country. The 880,000 jobs created in May 1984 exceeded the number of jobs created in the entire European Economic Community in the last 10 years.

Of these almost 8 million new jobs sixty-six percent were created by small businesses who are playing an increasingly significant role in our economic success. The Chamber applauds the interest the Administration has shown regarding the impact of this tax proposal on small business. We must ensure that these companies do not receive a major tax increase under any tax reform plan adopted. The retention of the graduated rates, which is part of the Administration's Proposal but not part of the November Treasury proposal or the Bradley-Gephardt plan, is an essential ingredient to any plan that will keep the economy growing.

Because payroll taxes have a direct effect on the cost of labor, we are concerned about proposals to tax worker's and unemployment compensation. Since the states set maximum benefit levels in each state for both workers' and unemployment compensation, taxation of these benefits (at the federal and state and local level, since most state taxation policy mirrors that of the federal government) will require increases in outlays to offset such taxation solely to maintain current net benefit levels. The federal government has its own workers' and unemployment compensation programs, and benefits under these programs would also face similar outlay increases to maintain current, net benefit levels. The increased benefit levels would be funded through increased payroll taxes, in the case of unemployment compensation, and increased premiums in the case of worker's compensation. The resulting increased payroll burden will affect an employer's decision to hire additional workers, especially for small businesses for whom the payroll tax cost of workers plays a significant role in their employment decisions. Increasing the payroll burden on employers (and, in turn, the ultimate cost to consumers of goods and services) will decrease the incentive to expand employment and exacerbate the ability of U.S. firms to compete abroad.

As over 80 percent of small businesses are unincorporated, the reduction in the tax rates for individuals will be a great help to them. Reductions in corporate and individual rates will provide more capital for business expansion, thus providing more jobs and greater economic growth. We feel that it is crucial to the economic success of this country that once the base is broadened in exchange for lower rates that these rates not be later be raised.

The differential between capital gains and ordinary income rates is also important to maintain. The retention of a capital gains rate helps to make venture capital available to businesses for expansion, which results in more jobs. The availability of venture capital is particularly important to small businesses who have a very difficult time attracting sufficient financing, again this being the segment of the business community presently producing the most jobs.

As noted above, the Administration's proposed Capital Cost Recovery System (CCRS) would increase substantially the cost to business of making investments in new plants and equipment. If these increased costs cannot be passed on through higher prices, businesses will not invest in new equipment. Given the difficult international competition which U.S. businesses presently face, it is unlikely that this increased cost of capital can be passed on through higher prices. This lack of expansion will have a negative impact on our rate of job creation.

The proposal to eliminate Industrial Development Bonds (IDB's) and severely limit the use of general obligation bonds may have several unanticipated consequences.

V. Business Pays A Fair Share

The American people have been subjected to a constant barrage of misleading newspaper articles about "undertaxed" corporations. The conventional wisdom is rapidly becoming that corporations simply do not pay their "fair" share.

Rumors of the death of the corporate income tax have been greatly exaggerated. As Table XVIII below shows, the average corporate income tax rate is over twice as high as that on individual income. If one takes into account all the federal taxes that corporations pay, they pay over 50 percent of their profits to the government. When state taxes are considered, the burden becomes higher still. Those claiming that the corporate tax is all but dead usually focus on its declining role as a source of federal revenues. But its reduced importance is primarily a function of the precipitous decline in the importance of corporations in American life. In 1950, corporate income constituted 14 percent of the Gross National Product while today it makes up only 6 percent. The bottom line is that American business pays a very high proportion of its income to the federal government.

TABLE XVIII
FEDERAL TAX BURDEN ON CORPORATIONS

FISCAL YEAR	CORPORATE INCOME TAXES AS % OF CORP. INCOME	TOTAL CORP. TAXES AS % OF CORP. INCOME	CORP. INCOME TAX RECEIPTS AS % OF TOTAL FED. REVENUES	CORP. INCOME AS % OF GROSS NATIONAL PRODUCT	INDIVIDUAL INCOME TAXES AS % OF IND. INCOME
1950	29	34	29	14	7
1960	44	51	28	10	10
1970	48	59	17	7	12
1975	41	58	14	7	10
1980	32	51	13	8	12
1981	31	53	10	7	12
1982	29	55	8	6	12
1983	21	51	6	5	11
1984	25	50	9	6	10

Note: Total taxes include federal unemployment taxes, employers' social security payroll taxes and the corporate income tax.

Those corporations that pay few taxes usually are not paying for one of two reasons. Most have lost money in prior years and are simply "carrying the losses forward." It is only fair that businesses be able to deduct losses incurred in prior years against earnings in the present year. Otherwise, net income is not being taxed. Yet, corporations that have lost money for years and finally earn money are lambasted in the newspapers as "profitable companies paying no taxes." Unless one sees some sort of justice in adopting a myopic year-to-year point of view, the present treatment of losses, where losses and gains are netted out, is correct.

Sometimes corporations pay few taxes when they have embarked on an aggressive investment program and the investment has not yet paid for itself. Our present capital cost recovery allowances approximate expensing. Under expensing, taxpayers do not begin to pay taxes until their investment has actually yielded sufficient profits to pay the cost of the investment. In other words, businesses do not pay tax until they have earned profits.

While there are deep controversies within the field of tax policy, it is generally agreed that there is no intellectual basis for the notion that corporations pay taxes. People pay taxes. Corporate income taxes are taxes paid by people, but collected from the corporate entity. Once this simple point is understood, it should be clear that measures of aggregate corporate effective tax rates should not be judged by comparing them to a 46 percent statutory tax rate "on" corporations. Instead, it is necessary to specify how individual income that is earned at the corporate level should be taxed under a well designed system of taxing peoples' income.

Economists do not agree on who actually bears the economic cost of the corporate tax. Many believe the tax is borne by owners of all capital, including that held by unincorporated businesses. Others argue it is borne primarily by corporate shareholders. Still others believe that a substantial portion of the tax cost is passed on to consumers in higher prices. Some believe that labor bears a substantial portion of the corporate tax burden in the form of reduced wages. The bottom line, however, is that we are not sure who actually pays the corporate tax.

Table XIX below shows the effective corporate tax rate including state and local corporate taxes and the double tax on corporate dividends.

TABLE XIX

EFFECTIVE CORPORATE TAX RATE

YEAR	A Corporate Income Taxes	B Corporate Income and Employers' Payroll Taxes	D Corporate State, Local and Federal Income and Payroll Taxes	E All Corporate Taxes and Individual Tax On Dividends
	As Percentage Of Corporate Income			
1950	29%	34%	37%	64%
1960	44	51	55	75
1970	48	59	64	77
1975	41	58	61	73
1980	32	51	55	69
1981	31	53	57	72
1982	29	55	60	77
1983	21	51	57	74

VIII. Employee Benefits

The U.S. Chamber supports the development and maintenance of a strong, voluntary, non-discriminatory, private sector employee benefits system, which can vary in accordance with the needs of employers and employees. Accordingly, proposals to subject employee benefits to taxation and further regulation are of concern to us.

The Reagan Administration had been correctly committed to less government intrusion into business. Its goals of privatization and deregulation of certain government services are shared and supported by the Chamber. New rules regarding distribution and nondiscrimination requirements for employee benefit plans would be inconsistent with these goals.

Incentives for business to offer health and insurance benefits to employees reduces the utilization of and pressure on government-provided services. Reduced regulation and taxation of employee benefit plans would reduce business costs and allow greater flexibility in choice of benefits for the workers. The Employee Benefit Research Institute estimates that the $100 billion worth of health coverage provided by employers to some 82 million workers costs the government less than one-third of that amount in foregone taxes. The replacement cost of similar health protection provided directly by the government would be the full $100 billion.

The Chamber encourages continued efforts toward privatization alternatives to government programs, such as individual retirement accounts, section 401(k) plans, and Keogh plans. Increased privatization will reduce reliance on the already overburdened Social Security system and provide better returns on worker investment.

Some provisions in the Administration's proposal would tax income before it is realized. The Chamber believes that income should not be taxed until recognized.

Employer-provided benefits thus fulfill a number of worthy objectives including: the maintenance of a less extensive and less costly Social Security system, avoidance of the burdens of a broadly-based national health system, encouragement of a sense of affiliation with an employer leading to increased employee productivity, providing an important source of savings and investment and substantial risk protection to American workers and their families against the vicissitudes of illness, unemployment and death of a wage-earner.

Under the proposed changes, many currently tax-qualified retirement plans will not maintain tax-qualified status, and numerous businesses -- especially small businesses -- will be discouraged from establishing retirement savings plans due to administrative complexity. The Social Security system may be called upon to provide a greater proportion of retirement security.

In short, employer provided benefits are serving an important function more efficiently and cheaply than the public sector could meet the challenge. New rules on the operation of benefit plans are contrary to the objectives of fairness and simplicity in the tax code and cause extreme problems for small business.

Conclusion

The Chamber commends the President on his tax reform package. It is a positive step towards the much needed reform that this country awaits. In 1981 President Reagan started down this path by supporting the changes included in the Economic Recovery Tax Act (ERTA). The economic response to ERTA is unsurpassed. Investment and GNP are rising, interest rates and inflation are low and declining and productivity has improved. However, the Administration's proposal must be improved to assure that it enhances economic growth in order to continue the spurt in the economy begun by the 1981 changes.

Congress now has the tremendous opportunity to design a tax reform plan which will continue to increase economic growth. The benefits of a dynamic economy flow to all Americans. But a growing economy is most fair to the least advantaged Americans, those that most need the improved living standards that only an improving economy can provide. To increase capital formation and enhance job creation, the Congress should improve the proposal's capital cost recovery system so it is equal to or better than present law. International competitiveness must not be impaired by our tax code. The foreign tax provisions of the proposal would lessen American business' ability to compete abroad.

The Chamber applauds the proposal's support of technological advancement by the retention of the R&D credit. The reduction in capital gains tax rates will spur capital formation and reduce the tax bias against risk-taking. The reduction of corporate and individual rates will increase the incentive to work, save and invest thereby increasing economic growth. Section 401(k) plans should be maintained. Not only do they add to the pool of capital available for investment, thus spurring economic growth, but also they reduce the utilization of and pressure on government provided services.

Never has this country been more ready for a sweeping change to our tax system. Support for tax reform is bi-partisan. Tax reform, properly conceived and executed, can fuel an unprecedented economic expansion. In crafting such a sweeping change in the tax system, Congress should provide for reasonable and fair transition rules so as not to disrupt normal business activity. The Chamber looks forward to working closely with the members of the Committee to craft a strongly pro-growth tax reform package.

ADVANCING VOLUNTARY LEADERSHIP IN A CHANGING WORLD

Chamber of Commerce of the United States
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APPENDIX

Survey of Taxation of Foreign Source Income by Certain Major Industrial Countries.

Set forth below is a review of the tax rules of other major industrial countries applicable to foreign source income earned by domestic corporations. This review shows that most foreign source direct investment income earned by foreign multinational companies is either exempt from home country tax or, if taxed, is subject to the equivalent of an overall limitation. To briefly summarize these descriptions, foreign source direct investment income earned by multinational companies based in Australia, France and the Netherlands is generally exempt from home country tax. Germany (by treaty) and Italy (by dividend exemption) also allow for significant exemption of foreign source income. Belgium exempts most foreign source income, and any foreign source income subject to tax can be offset by foreign tax credits computed under an overall limitation. Japan taxes foreign source income with foreign tax credits limited to one tier but computed under an overall limitation. Even in the United Kingdom, where a form of per country limitation is employed, averaging of high and low foreign tax rates has been achieved via an appropriate foreign corporate structure (as was the case with the per country limitation under prior U.S. law).

AUSTRALIA

A resident corporation of Australia is technically liable for Australian corporate tax on its worldwide income. Double taxation is avoided by a combination of tax exemptions, rebates and credits. Foreign subsidiaries of Australian corporations are not taxed in Australia (i.e. no global assessments), but dividends, etc., remitted to Australia are subject to the rules set out below.

The foreign branch income of an Australian corporation is not taxable in Australia, provided the income is subject to tax in the country of source. (This rule applies even if the foreign tax rate is considerably less than the Australian tax rate.)

Dividends received by an Australian corporation from a foreign corporation are includable in taxable income. However, the foreign dividends, provided they relate to non-Australian source income, are effectively received tax-free as the Australian tax applicable thereto is fully rebated. In the case of closely held corporations, this rebate is conditional upon the dividend being redistributed to individual shareholders within 22 months, failing which tax at 50 percent of the undistributed amount is payable.

Interest derived by an Australian corporation from foreign sources is exempt from Australian tax, provided the interest is taxed in the country of source. If the foreign tax applicable to the interest is limited by the terms of a tax treaty, the interest is taxable in Australia with the allowance of a foreign tax credit.

Royalties received by an Australian corporation from foreign sources are exempt from Australian tax, provided they are taxed in the country of source. If the foreign tax applicable to the royalties is limited by the terms of a tax treaty, the royalties are taxable in Australia with the allowance of a foreign tax credit.

The above foreign tax credits are limited to the amount of Australian tax otherwise applicable to the income received. The tax credit is calculated separately for each item of income.

BELGIUM

Belgian corporations are technically subject to corporate income tax on their total income, including income derived from foreign sources.

Income from foreign branches forms part of a Belgian corporation's taxable income. The Belgian corporate income tax is, however, reduced to one-fourth on foreign branch income that has already been taxed abroad. Furthermore, the income of a foreign branch is fully exempted from Belgian corporate income tax when such branch is located in a country with which Belgium has concluded a tax treaty.

Dividends received by a Belgian corporation from foreign sources are subject to Belgian corporate income tax. However, a deduction equal to 95 percent of dividends received is allowable in computing taxable income, provided that the shares which generated such dividends were held by the taxpayer company for its entire fiscal year. If the shares were not held during the entire year, the dividends are fully taxable, but a flat foreign tax credit of 15 percent of the dividends received is allowed.

Foreign source interest and foreign source royalties form part of the normal taxable income of a Belgian company. A flat foreign tax credit of 15 percent of the amount received is granted if the income was subject to withholding tax at source.

Belgian foreign tax credits are subject to an overall limitation.

CANADA

Corporations resident in Canada are subject to Canadian federal income taxes on their worldwide income, subject to credits for foreign income taxes paid on income derived from non-Canadian sources. Under Canadian law, dividends are exempt from taxation if received from a subsidiary in a treaty country. Canada has entered into a broad tax treaty network.

Canadian law does not provide for a foreign tax credit for the underlying foreign taxes attributable to dividends received by a Canadian corporation from a foreign affiliate. In lieu thereof, Canadian law provides that such underlying foreign taxes are eligible for a deduction on a formula basis in computing the Canadian corporation's taxable income. In addition, any foreign withholding taxes imposed on the dividend are subject to a deduction-from-income mechanism (rather than a tax credit). The total deduction is computed under a formula that is designed to result in the imposition of Canadian tax and foreign underlying and withholding taxes on the dividend from the foreign affiliate at a rate equivalent to the Canadian corporate tax rate. If a Canadian corporation receives a dividend from a first-tier foreign subsidiary and such dividend is derived from the earnings of both the first-tier foreign subsidiary and a second-tier foreign subsidiary, the earnings and the foreign taxes of the two subsidiaries are aggregated for purposes of computing the Canadian deduction.

A Canadian corporation is entitled to claim a credit for foreign taxes paid on foreign branch income as well as foreign withholding taxes.

The foreign tax credit is allowed to Canadian corporations on a per country basis on dividends received from a subsidiary in a non-treaty country.

FRANCE

The French tax system is based on the principle of territoriality. Except for a few limited situations, French tax law is not applicable to business activities conducted outside French territory. Thus, income earned by a foreign branch of a French corporation is generally not subject to French income tax.

French parent companies receiving dividends from their foreign (or domestic) subsidiaries benefit from a "participation exemption." To qualify for the participation exemption, the French corporation must hold shares representing at least 10 percent of the issued capital of the subsidiary. A qualifying parent company receiving a dividend from the affiliate may deduct from its taxable income an amount equal to 100 percent of the dividend received, but should disallow deductible expenses up to an amount equal to 5 percent of the gross dividends received (or less if the expenses of holding the shares, incurred by the parent company, are not high).

Foreign source dividends not qualifying for the participation exemption, foreign source interest, and foreign source royalties are includable in the taxable income of a French corporate recipient. If the foreign source country has concluded a tax treaty with France, foreign tax credits may be claimed for foreign withholding taxes imposed on the payments. The credit for withholding taxes paid to a treaty country is limited to the amount of French income tax due on the payments from the treaty country. In the absence of an income tax treaty, French law provides for a deduction (rather than a credit) for foreign taxes, i.e., income is recorded by a French taxpayer net of foreign taxes.

GERMANY

German corporations are liable for German corporation tax on their worldwide income whether derived from German or foreign sources. However, under most tax treaties concluded by Germany, profits of a foreign branch are exempted from German corporation tax. Profits of German companies in nontreaty countries or in treaty countries where the treaty does not provide for an exemption of branch profits are subject to German corporation tax, but a tax credit is given under German internal law for foreign income taxes paid. There are some German treaties, such as the treaty with Switzerland, which exempt profits of a branch in the other treaty state only if the branch engages in active business operations.

Dividends received by a German corporation with respect to a 10 percent or more shareholding in a company situated in a treaty country are generally exempt from German corporation tax under the provisions of the treaty. Dividends received by a German corporation with respect to a 10 percent or more shareholding in a company situated in a nontreaty country are taxable in Germany for corporation tax purposes. In this situation, income taxes paid by the foreign subsidiary are claimable by the parent under the indirect foreign tax credit rules even though they are paid by the subsidiary. Thus, the parent company can credit foreign income taxes paid by the subsidiary, as well as foreign withholding taxes paid on the dividend income, against its own corporation tax liability.

Interest and royalties received by a German corporation from foreign sources are subject to German corporation tax. A foreign tax credit is given for any foreign income taxes withheld on such payments.

The German foreign tax credit is computed on a per country basis.

ITALY

An Italian corporation is subject to Italian corporate income tax on all income, whether produced in Italy or abroad. A foreign tax credit is allowed for foreign taxes paid on a corporation's foreign source income determined on a country by country basis.

Only 40 percent of the dividend income received by Italian companies from foreign-associated companies (generally, more than 10 percent stock ownership) is included in taxable income for corporate income tax purposes. Foreign withholding taxes imposed on the dividends are eligible for foreign tax credit. In a recent ruling, the Ministry of Finance, clarified that whenever the taxpayer benefits from the 60 percent exclusion, the credit is limited to 40 percent of the foreign withholding tax.

The amount of foreign tax credit depends on the reciprocity of treatment between Italy and the income-source country. If the foreign country grants a tax credit or an exemption for income of the same nature available in Italy, the tax paid abroad is credited against the Italian income tax but in an amount not exceeding that part of the Italian tax that is attributable to the foreign income. If the foreign country does not grant a tax credit or an exemption for income of the same nature available in Italy, a credit of up to 90 percent of Italian taxes attributable is given if the income was business income, or 50 percent if nonbusiness income. The tax credit cannot exceed the foreign taxes paid.

JAPAN

A Japanese corporation is subject to Japanese corporate income tax on its worldwide income.

A Japanese corporation is entitled to a tax credit against Japanese corporation tax for foreign income taxes paid. Foreign income taxes qualifying for the credit include foreign taxes that are imposed on the net income of a corporation or on gross revenue in lieu of a tax on net income, i.e., income tax imposed at source on interest, dividends, royalties, etc.

Creditable foreign income taxes include not only foreign income taxes imposed directly on a Japanese corporation but also foreign income taxes paid by certain foreign affiliates. This indirect credit is available to a Japanese corporation when it receives a dividend from a foreign corporation in which it owns directly at least 25 percent of the total issued shares. (Some tax treaties that Japan has concluded provide for a requisite percentage control lower than 25 percent. For example, the United States-Japan tax treaty provides that the requisite control is 10 percent of the total issued shares.)

The Japanese foreign tax credit limitation is computed on a worldwide basis. Thus, the total amount of foreign tax credit that may be claimed cannot exceed the amount of (pre-credit) Japanese corporate tax allocable to net foreign source income.

NETHERLANDS

A Dutch resident corporation is technically subject to Dutch corporate tax on its worldwide income. Double taxation of foreign source income is relieved through a variety of measures which employ either exemptions from income or foreign tax credits.

Foreign branch profits of a Dutch corporation are included in the worldwide income of the Dutch corporation and are subject to Dutch corporate tax. However, the Dutch corporation receives relief on its Dutch tax liability, i.e., if the foreign source income is subject to foreign income tax, the aggregate Dutch tax liability on worldwide income is reduced by the proportion that the foreign income bears to total income. This relief is tantamount to a full exemption from Dutch corporate tax of the foreign income concerned. The requirement that a foreign branch is subject to a foreign income tax in order to qualify for relief from double taxation, is deleted under most, but not all, tax treaties concluded by the Netherlands.

A Dutch corporation is exempt from Dutch taxes on all "benefits" connected with a qualifying shareholding, i.e., a "participation exemption." If a Dutch corporation owns at least 5 percent of the capital of a foreign corporation, if the foreign affiliate is not an investment company, and if the foreign affiliate is subject to an income tax in its home country, then dividends received by the Dutch corporation from the foreign affiliate qualify for the participation exemption and thus are exempt from Dutch corporate tax. In cases where the participation exemption does not apply, net dividends from abroad (after deduction of foreign taxes as an expense) are taxable in the Netherlands. The "participation exemption" exempts from corporate income taxes all benefits derived from a "qualifying participation." Capital gains (or losses) derived from a disposition of the stock are included in the term "benefits." The criteria to determine whether a shareholding in a foreign corporation qualifies as a "participation," is that the Netherlands company must own the stock as a participation as opposed to a portfolio investment. Such criteria generally implies that the foreign company itself cannot be a portfolio investing company. However, in BNB 1974-2 the Dutch Supreme Court held that the investment by a Netherlands company in 100 percent of the stock of an active German trading company can still constitute a portfolio investment and hence, not a participation for the Netherlands parent company. In its judgment in this case, the Supreme Court considered that the Netherlands company itself was a mere holding company managed by a bank, apparently without sufficient activities as a real holding company of a commercial or industrial group to indicate that the holding was not investing in the trading company as a portfolio investor. Pursuant to this court case, the Secretary promulgated a public ruling indicating that it was the view of the Ministry of Finance that, in similar situations the participation exemption would apply if the Netherlands holding company was an interposed holding company whereby the real group holding function is performed by a company or companies which are the direct or indirect parent company of the Netherlands company.

In addition to the relief method which applies to profits derived by a Netherlands company through a foreign branch, the Netherlands grants a credit for foreign source taxes on dividends, interest and royalties derived from developing countries. The right to a credit for foreign income taxes on dividends, interest and royalties are extended to tax treaty countries (in addition to developing countries) under applicable tax treaty. No credits are available for foreign income taxes levied on dividends which qualify for the participation exemption. The herein described foreign tax credit is limited by the lesser of (i) the amount of the foreign tax or (ii) the amount of the Netherlands tax otherwise applicable to the dividends, interest and/or royalties net of directly attributable expenses. For dividends a third limitation applies which equals a flat 25 percent of the dividends received. In principle, the credit for these categories of income operates as an overall limitation with an 8-year carry forward of excess foreign tax credits. Instead of applying the foreign tax credit, a Netherlands taxpayer can opt to deduct rather than credit the foreign tax on dividends, interest and royalties.

It might be important to note that the participation exemption is not considered as a special measure for the relief from international double taxation. It is not dealt with in either tax treaties or the unilateral method for relief from international double taxation. Rather, it is an integral part of the corporate income tax act which applies equally and indiscriminately to the domestic and foreign participations, although the requirements to qualify for the participation exemption with respect to a foreign participation are somewhat more extensive.

Interest and royalties from foreign sources are taxed as any other corporate income, with relief provided through the foreign tax credit mechanism.

The foreign tax credit allowed is the lesser of (i) the actual amount of foreign tax withheld or (ii) the amount of Dutch tax otherwise applicable to the interest and/or royalties.

UNITED KINGDOM

A U.K. resident company is subject to U.K. corporation tax on its worldwide income. Double taxation is reduced on foreign source income through the allowance of a foreign tax credit.

Where the foreign income consists of a dividend from a foreign corporation, the creditable foreign taxes include (i) any foreign tax withheld on the dividend payment, and (ii) the foreign income taxes paid by the foreign corporation on the underlying profits out of which the dividend is paid, provided the U.K corporation holds directly or indirectly at least 10 percent of the voting power of the foreign corporation.

The amount of U.K. foreign tax credit allowed is limited to the lesser of (i) the foreign tax paid on the particular income or (ii) the U.K. tax otherwise attributable to that particular income. Where foreign operations are conducted through a foreign subsidiary structure, foreign earnings and foreign taxes are generally aggregated at the first-tier level in computing the credit on a distribution up the tiers to the U.K. parent corporation. When aggregating the foreign tax credit at the first tier level, the underlying tax of lower tier companies from which a dividend is received, can be taken into account (insofar as they have paid dividends up the chain) provided that at each link in the chain there is ownership of at least 10 percent of the voting power. Therefore in a case where A has a wholly owned subsidiary located in a foreign country and B owns 15 percent of C which in turn owns 15 percent of D, underlying tax can be claimed in respect of all three companies, B, C and D, to the extent to which their profits have been ultimately distributed by way of dividend through to the U.K. company, A. Aggregating the credit at first tier level means that effectively you can pool high rate and low rate credits and thus overcome the problem that might arise if a dividend from a high tax country were remitted direct to the U.K. giving rise to excess credit while, at the same time, a dividend from a low tax country remitted to the U.K. gives rise to additional tax payable. Putting the low tax country company under the high tax country company will enable a blending of the rates, though it may generate a higher level of withholding tax.

Where two or more dividends are received by a company in the same accounting period the limitation must be applied in relation to each separate dividend.

Under U.K. law, interest costs are not attributable to foreign source income unless those interest costs have actually been incurred in the company receiving the foreign source income. In this way, a U.K. company may borrow for the purposes of an overseas investment, apply the funds received in paying up share capital for a subsidiary company and the subsidiary company then makes the investment. The foreign source dividends received by the subsidiary company attract full tax liability, subject to double taxation relief. Those dividends when received can then be passed on by way of dividend to the parent company with a neutral tax effect. The parent company sets off the interest cost either against other U.K. source taxable income or, if it does not have sufficient income of that nature, it sets it off by way of group relief against U.K. source income of other U.K. subsidiary companies.

STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, DC

Mr. HUARD. Thank you, Senator. I agree with my colleague, Dr. Rahn. The President is to be commended for bringing the tax reform issue to the forefront of congressional consideration.

His proposal, however, is very much a Jekyll and Hyde proposition. It has some very, very good points which we support, and some very, very bad ones which we oppose. These are set forth in our testimony, which I understand will be printed in full for the record of this hearing.

To briefly summarize the major items, we strongly support the proposal to significantly reduce marginal tax rates for both corporations and individuals and to provide a partial deduction for dividends paid. These provisions will go a long way toward ameliorating the excessive bias of the Federal tax system against income from work, savings, and investment. They will also help reduce the admittedly wide disparities in effective tax rates which occur under the present system.

The principal negative features of the plan are, first, the proposal for a massive $260 billion increase in taxes on capital investment and, second, the numerous adverse changes in the foreign income area. In combination, these features will cause a significant reduction in business investment and likely will lead to a noticeable reduction in economic growth over the next few years. Such changes will also exacerbate the problems already being faced by many U.S. manufacturers in competing in world markets.

Now, on that issue, I would like to say that we tend to agree with the comments of Treasury Secretary Baker that many of the international competitiveness problems of U.S. companies relate to nontax factors like exchange rates, wage rates; but while that may be true, it strikes me as a singularly inept approach, if I may use an analogy, to take a drowning man and throw him an anvil.

Our recommendations with regard to the President's reform proposal may be summarized briefly. We think that the proposed recapture tax should be scrapped entirely. We believe that the existing capital recovery system, or something reasonably equivalent to it, should be retained; and we suggest that the foreign source income provisions be left as they are without change. We certainly recognize that such recommendations, if adopted, will have a significant revenue impact, and that Congress will probably be required to examine other offsetting changes. In this regard, we strongly recommend that you consider steps to strike a better balance in the Federal tax system between the taxation of income, which is excessive, and the taxation of consumption, which is clearly insufficient.

I think one of the major problems that we see with the overall reform effort, both the Ways and Means version and the President's version, is the tendency to use the corporate community as a whipping boy and to finance politically attractive individual rate reductions with large increases on the corporate sector. I suspect in some other testimony this morning you may hear little anecdotes about corporations not paying taxes. I would hope that, while you are considering these selected little pictures of corporations, you will also consider the big picture. The big picture is that personal income in this country is around $3 trillion, and the Federal Government collects about 10 percent of that in income taxes from individuals. Corporate profits will run $275 to $300 billion, and of that, the Federal Government collects 25 to 30 percent in corporate income taxes. So, in terms of the proportional burden, corporations are already paying 2.5 to 3 times more than individuals in income taxes.

And that just considers Federal income taxes. If you add in State income taxes, the number rises to 40 percent. If you add in the crushing burden of ever-increasing payroll taxes, you find that the taxes being paid by corporations to support the functions of Government equal approximately 80 percent of their profits. That concludes my comments. I will be glad to answer any questions the panel may have.

Senator BAUCUS. Thank you, Mr. Huard.

Mr. McIntyre.

[The prepared written statement of Mr. Huard follows:]

STATEMENT OF PAUL R. HUARD
VICE PRESIDENT, TAXATION AND FISCAL POLICY
ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
SENATE FINANCE COMMITTEE
ON THE PRESIDENT'S TAX REFORM PROPOSAL
OCTOBER 2, 1985

I am Paul R. Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers (NAM).

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nations's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on President Reagan's tax reform proposal.

I. Introduction

At the outset, I wish particularly to stress that NAM neither supports nor opposes the President's tax reform plan as a whole. Indeed, we see no pressing need to take a definitive position for or against the plan at this time. Clearly, one of the safest observations that can be made about the current tax reform debate is that neither the House nor the Senate will ever be asked to vote "yes" or "no" on this plan in its present form. Rather, it is apparent that the tax-writing committees of the House and Senate each intend to make substantial changes to the President's plan before reporting tax reform bills to the floor of their respective bodies.

In saying this, I do not mean to suggest that tax reform is a dead issue. On the contrary, it is very much a live one, and the probability remains very high that Congress will send the President a major tax reform bill before the next election. Moreover, NAM is strongly supportive of the overall effort to reform and improve the federal tax system. Accordingly, we believe we can contribute most constructively to the process by pointing out both those elements of the President's plan that we find to be sound and which should be retained, as well as those we view as ill-advised and which should be dropped.

Let me begin then by summarizing those elements of the plan that NAM strongly favors.

NAM supports substantial reduction of the marginal tax rates for individuals. This change would be a significant—though at best partial—step forward in reducing the bias of the existing tax system against savings and investment. Further, in the particular context of small business, it is of great significance to those many millions of unincorporated businesses that are taxed on business profits under the rate structure for individuals.

NAM likewise favors substantially lowering the top corporate tax rate and providing a partial deduction for dividends paid to shareholders. These two changes would help substantially in reducing the extreme disparities in effective corporate tax rates that occur under the present system. We feel quite strongly that compression from the top down--through rate reduction and dividend deductibility—is by far the most preferable technique for narrowing such disparities, which admittedly are too wide. It would, on the other hand, be an extremely misguided and dubious expedient to try to alleviate this problem by raising the taxes of those companies making heavy commitments to improved productivity and competitiveness through substantial investments in productive machinery and equipment.

NAM also supports retention of a graduated tax rate structure for the first $75,000 of corporate taxable income. This approach permits small businesses to retain a greater portion of their earnings, thus providing a much-needed internal source of capital. From a small business standpoint, lack of a graduated corporate rate was one of the single biggest drawbacks of the November 1984 Treasury reform plan, and one which NAM strongly urged the Administration to correct before endorsing the plan and sending it to the Congress. We obviously are very pleased that they did so.

Finally, NAM is in favor of retaining a preferentially low rate of tax for capital gains. Failure to do so is likely to cause a sharp reduction in the availability of venture capital, a generally undesirable effect and one that would be felt most heavily by small and fledgling businesses, which are more limited in their ability to obtain capital financing than are larger, more well-established companies.

Offsetting the favorable changes just described are a number of changes NAM cannot support. Foremost among these is the drastic curtailment of incentives for capital investment in productive machinery and equipment. Over the period 1986-90, the President's plan would increase taxes on capital by some $260 billion. This would occur in three ways: first, through immediate and outright repeal of the investment tax credit; second, through repeal of the Accelerated Cost Recovery System (ACRS) and substitution of a less accelerated depreciation system; and third, through imposition of a retroactive tax on ACRS deductions taken in prior years.

Such changes, if implemented, will lead to a number of highly undesirable consequences that will be particularly pronounced in the case of industries which are capital-intensive. They will retard future capital investment while penalizing past capital investment. They will lower productivity and impair the ability of U.S.-produced goods to compete against foreign-produced goods in both domestic and international markets. They will further encourage imports at the expense of U.S. products and jobs and thus worsen existing trade imbalances.

The President's plan also includes changes in the treatment of foreign source income, most notably with regard to computing the foreign tax credit limitation and determining the source of income and deductions. We have examined such changes and believe that, if adopted, they will exacerbate the international competitiveness problems of U.S.-based companies with overseas operations.

We believe that the defects noted above can be remedied substantially by making the following changes:

- retaining the present type of capital recovery system, which combines an investment tax credit with accelerated depreciation over short recovery periods, or if this is not feasible, by adopting expensing (or its economic equivalent) for machinery and equipment;

- — eliminating the proposed "recapture" tax on prior depreciation deductions and modifying the proposed corporate alternative minimum tax so as to remove penalties imposed on prior investment; and
- — retaining existing rules on computation of the foreign tax credit limitation and on the determination of the source of foreign income and expense items.

We recognize, of course, that these changes will reduce the revenues needed to keep the tax reform plan "revenue neutral," and that Congress will be required to examine other offsetting changes to make up the difference. When it does so, we urge each member to keep the following in mind: revenue neutral tax reform can be and should be achieved, but this should not be done at the expense of economic growth and stability and not disproportionately at the expense of productive capital investment and the ability of U.S. companies to compete and provide jobs.

In this context, I would like to draw your attention to a resolution adopted unanimously by the NAM Board of Directors in October 1984. That resolution, the full text of which is reproduced as Appendix A to this Statement, was developed in the context of the nation's deficit problem. Essentially, the thrust of this resolution is that, while spending reductions should be the primary technique for lowering deficits, if Congress nevertheless decides to increases revenues as part of a balanced deficit reduction program, such revenue increases should be in the form of consumption-based taxes. In addition, the resolution of our board clearly anticipated that a shift towards taxation of consumption rather than income might occur in conjunction with a restructuring of the existing tax system. In pertinent part, this unanimously-adopted resolution of NAM's board states:

> Revenues from a transaction-based consumption tax should be used in part to replace revenues from the existing income tax system, thus reducing the government's excessive reliance on the taxation of individual and corporate income, permitting a general lowering of income tax rates and facilitating the process of tax reform and simplification. Revenues not so used should be dedicated solely to deficit reduction.

The balance of this statement elaborates somewhat on the plan's major pluses and minuses, most of which have already been outlined above. The statement concludes with an articulation of the view that, while reform and simplification of the tax laws are highly desirable, it would not be in the public interest to do so in a manner that seriously impairs the productivity and competitiveness of a large part of the manufacturing sector.

II. Positive Aspects of President's Tax Reform Plan

A. Taxation of Individuals. While our observations on the President's plan focus primarily on the business and corporate provisions, a few general comments on the proposed individual income tax changes are appropriate. A long-standing article of NAM tax policy is that tax rates on both personal and corporate income should be moderate at all points. We therefore applaud and support the President's proposal to reduce substantially the marginal rates of taxation for individual taxpayers.

Dropping the marginal rates of taxation, together with such other parts of the proposal as the lowering of the maximum capital gains tax rate, also furthers another NAM-supported tax policy goal: the reduction of biases in the existing tax system against savings and investment.

Moreover, the individual rate reductions are of crucial importance to those many millions of owners of unincorporated businesses who pay tax on their business profits under the rate structure for individual taxpayers. Having said this, it is only fair to note that individual rate reductions probably are more significant for small businesses generally than for small manufacturers in particular. It is commonly said that about 7 out of 8 businesses are unincorporated. This ratio, however, does not hold in the manufacturing sector, where the vast majority of firms are incorporated in order to reduce the owners' exposure in such areas as product liability. For most small manufacturers, then, it is the corporate tax changes which will tend to be of greater significance.

B. Corporate Taxation Changes. We are very pleased to observe that two of the very best features of the November 1984 Treasury plan have been retained in the President's proposal. The first of these is the proposed reduction in the top corporate rate from 46% down to 33%, which has been retained intact. The second is the proposal to permit a partial deduction for dividends paid to shareholders, thereby mitigating the double taxation of corporate earnings which occurs under the present system. While we regret that the portion deductible has been greatly reduced—from 50% in the earlier plan down to 10%—it still is an important conceptual step forward to establish the principle of deductibility at this time. We therefore most strongly urge that this provision be retained in the plan and suggest that at the earliest feasible opportunity the percentage of deductibility be increased substantially, with 100% deductibility being the ultimate objective.

Taken together, rate reduction and dividend deductibility represent the preferred solution to the problem of excessively wide disparities among effective corporate tax rates. In the case of many small manufacturers, however, dividend payouts are often negligible or nonexistent, so that for these companies corporate rate reduction is by far the more meaningful component of the solution to the high effective rate problem. In this regard, restoration of a graduated rate structure on the first $75,000 of corporate taxable income is perhaps the single biggest improvement the President's plan has made relative to the Treasury's original version.

Under the November 1984 Treasury plan, the present system of graduated rates would have been abandoned, and the top corporate rate of 33% would have applied from the very first dollar of a corporation's taxable income. As a result, many small businesses with only modest amounts of taxable income would have had their tax bills more than doubled, a situation as unjustified as it was intolerable. Now, at least, small businesses will be no worse off under the President's proposed corporate rate structure than under present law. Table 1 shows the impact of the proposed new rate structure at two income levels, $50,000 and $100,000.

Table 1

	$50,000 Taxable Income	$100,000 Taxable Income
Tax under present law	$8,250	$25,750
Tax under President's plan	$8,250	$22,750
Percent change	none	-12%

Since the first two brackets under the President's plan (15% on the first $25,000, 18% on the second) are identical to present law, the President's plan does not give rise to a reduction in tax liability at all until corporate taxable income reaches a level in excess of $50,000. At much higher income levels the greatest percentage change, of course, is -28%, which is the amount of reduction that occurs by dropping from a maximum rate of 46% to a maximum rate of 33%. The foregoing, it should be noted, is the "best case analysis" and assumes, somewhat charitably but at least still plausibly, that the corporation's taxable income was not otherwise increased by other base-broadening aspects of the President's plan.

C. Capital Gains Taxation. A major flaw in the November 1984 Treasury plan was the proposed elimination of preferential treatment for capital gains. Taxing capital gains as ordinary income—even with inflation-indexing of basis—would have dampened severely the willingness of many investors to make risky venture capital type investments. The ensuing reduction in the amount of available capital would have been felt most sharply by smaller businesses, who tend to be more limited in their ability to obtain capital financing than are the larger, more well-established companies.

We therefore are quite pleased to see that the President's plan would restore capital gains treatment for equity investments by providing a 50% exclusion for such gains. While this is lower than the 60% exclusion contained in present law, when applied to the new top personal rate of 35% it actually would result in a slightly lower maximum capital gains tax rate—17.5%—than the 20% which occurs under present law with its 50% top personal rate. This modest reduction should not be of concern from a revenue standpoint, however, since past experience has confirmed that, in addition to enlarging the venture capital pool, decreases in capital gains taxation increase rather than decrease revenues.

D. Incentives for Technological Innovation. NAM believes it is appropriate that the nation's tax laws include positive incentives for the technological innovation that is so essential to improved productivity and competitiveness. We are therefore pleased that the President has proposed extending, through 1988, the 25% tax credit for incremental R&D expenditures. We suggest, however, that certainty in the business planning process would be greatly enhanced by making this credit permanent. Along the same line, we believe Congress also should make permanent the temporary legislative moratorium on Treasury regulations under Internal Revenue Code Section 861 that, if permitted to go into effect again, would require allocation of domestic R&D expenses to foreign source income.

III. Negative Aspects of President's Tax Reform Plan

A. Provisions Impairing International Competitiveness. NAM is seriously concerned that certain elements of the President's tax reform plan will adversely affect the ability of U.S.-based manufacturers to compete against foreign-based producers in both domestic and international markets. A related result will be an increased demand for imports and a further worsening of existing trade imbalances. Those elements of the plan causing the greatest degree of concern in this regard are identified below.

1. Loss of Investment Tax Credit. The President's tax plan would repeal the investment tax credit (ITC), effective January 1, 1986. This would be a substantial retreat from the objective--long supported by NAM and finally achieved under the President's historic 1981 Economic Recovery Tax Act--of providing U.S. manufacturers with a capital recovery system as good as those available to our competitors based in other major industrialized countries.

While the Capital Cost Recovery System (CCRS) contained in the President's plan is arguably of a value equivalent to the present Accelerated Cost Recovery System (ACRS), at least when a certain degree of inflation is assumed, it is by no means of equivalent value to the combination of ACRS plus the ITC. Repealing the ITC and making CCRS the sole element of our capital recovery system will mean a return to the pre-1981 situation where the capital recovery available to a U.S.-based producer will be generally inferior to what would be available to competitors based in most other major industrialized nations.

Repeal of the ITC would increase the tax burden on capital-intensive companies by about $165 billion over the next five years. Among the reasons advanced for its repeal are that it is an obstacle to achieving neutrality among various types of business investment. In response to this, we would note that perhaps the most neutral approach to treating business investment in productive machinery and equipment would be to permit expensing. While NAM certainly would support such an approach, the revenue drain it would entail clearly appears much too large to permit implementation of expensing at this time.

The next best alternative is a system under which the present value of the stream of deductions and credits is roughly equivalent to expensing. This is exactly the result produced by the combination of ACRS and the ITC, and we would urge that Congress avoid adopting any substitute capital recovery system whose present value is less than the value of first year expensing.

In the case of small manufacturers, loss of the ITC will be felt most acutely at the lower income levels. This is illustrated, at both the $50,000 and $100,000 income levels, in Table 2 below. These illustrations assume that, in arriving at taxable income under present law, the corporation made capital expenditures of $30,000: $10,000 in the 3-year ACRS class and $20,000 in the 5-year ACRS class. It is further assumed that the 5-year ACRS property would be Class 4 property under CCRS.

Table 2

	$50,000 Taxable Income	$100,000 Taxable Income
Tax under present law	$6,450	$23,950
Tax under President's plan	$8,366	$22,866
Percent change	+30%	-5%

The changes illustrated above are due almost entirely to the lack of an ITC. The substitution of CCRS for ACRS has a fairly small effect, increasing taxable income slightly to $50,350 and $100,350, respectively. The loss of the ITC, on the other hand, has a fairly dramatic effect, particularly at the $50,000 income level. Indeed, even at the $100,000 income level the effect is pronounced, resulting in a tax decrease well under half the size of the 12% cut which would pertain in the case of a corporate taxpayer with similar income but no capital expenditures. (See Table 1, page 8.)

2. Substitution of Less Accelerated Depreciation System. The proposed Capital Cost Recovery System (CCRS) is, in essence, a variant form of the present Accelerated Cost Recovery System (ACRS) and would retain some of the best features of that existing system. Indeed, even though the CCRS recovery periods would be somewhat longer than under ACRS, the present value of the deductions under the new system would under some economic conditions be just as good as or better than under ACRS due to the inclusion of inflation-indexing, a feature ACRS does not have.

Having said this, a number of cautionary notes are necessary. First, CCRS compares favorably with ACRS only on the narrow basis of a comparison between two depreciation systems. If the field is broadened to a comparison of the existing and proposed capital recovery systems, then the existing capital recovery system, which combines ACRS with an ITC, is most decidedly superior to the proposed capital recovery system, which would consist solely of CCRS. (See Appendix B.)

Also, while CCRS is an accelerated system, it is not as accelerated as ACRS, so that its substitution for ACRS would raise $37 billion over 1986-90. This means, among other things, that the up-front cash flow from CCRS will be less than under ACRS. This will probably be a relatively greater disadvantage for smaller manufacturers, who typically will not find it as easy as their larger brethren to borrow on the strength of the present value of future deductions.

Finally, it must be observed that inflation-indexing is to some extent a very mixed blessing. Without it, CCRS would be a totally inadequate substitute for ACRS, since there then would be nothing to offset the longer CCRS writeoff periods. The problem, to be blunt, is the degree to which taxpayers can actually rely on the availability of inflation-indexing. In this respect, the track record to date offers precious little comfort.

Since the enactment of ACRS in 1981, Congress and the Administration have displayed a marked propensity for tinkering with it at frequent intervals. Lately, these intervals have been measured in months rather than years. Now, with the advent of the retroactive ACRS "recapture" tax in the President's plan, a new high-water mark of sorts has been established. Not only is it impossible, for investment planning purposes, to rely on the availability of ACRS in the future, one can no longer even rely on ACRS deductions taken in the past.

Under these circumstances, business taxpayers can reasonably be expected to be skeptical of a depreciation system whose adequacy depends so heavily on the promise of future adjustments for inflation. Indeed, who could blame them for assuming that, should high rates of inflation return at some time in the future, the likely Congressional response would be prompt action to curtail or repeal the inflation-indexing feature of CCRS? Given all of this, there is much to be said for simply retaining ACRS in its present form.

3. Recapture Tax on Alleged ACRS "Windfall". One of the most controversial elements of the President's tax reform plan is the unprecedented proposal to recapture nearly $57 billion in the tax benefits associated with past deductions taken under ACRS. The supposed justification for this is that the proposed lowering of the corporate tax rate to 33% would confer unintended or "windfall" benefits unless this recapture tax is imposed on "excess" depreciation taken while the current 46% rate was in effect.

It is, however, extremely doubtful that there would be any "windfall" in the vast majority of cases. Indeed, the hypothesis that there would be is supportable, if at all, only by looking at the interplay of ACRS deductions and the proposed rate reduction in a vacuum instead of considering the overall effect of the President's plan on capital-intensive companies. In the real world, most companies that invest heavily in new plant and equipment do so on a nearly continuous basis. Predictably, the burden of this proposed recapture tax will be concentrated on those companies that—far from enjoying any "windfall"—will already be paying much higher tax bills under the President's plan than they would under current law, due in large part to the repeal of the investment tax credit.

The proposed "recapture" tax suffers from numerous other defects. First, since the company paying it need not actually realize income at the time and in the amount assumed under the recapture provision, it is in reality an ex post facto excise tax on prior investments. Such a retroactive tax on transactions already consummated is of questionable constitutional validity.

Second, the narrow scope of the recapture tax is patently unfair, since it is limited to prior depreciation deductions and does not apply to other items through which a taxpayer may have deferred income at a time when rates were higher than they will be in the future. Two examples which come immediately to mind are installment sales and IRA deductions.

Finally, the calculations underlying the recapture tax involve some highly doubtful assumptions. One is that the "excess" depreciation in the case of 5-year ACRS property, for example, is properly measured by assuming the property should have been depreciated over 12 years. It is clear that in some industries a great deal of such property actually becomes obsolete at a much faster rate. [Moreover, if the 12 year period is appropriate, it certainly is unfair to recapture the so-called "excess" depreciation over a much shorter period.]

Another faulty assumption is that the taxpaying corporation would have had an effective tax rate of 46% in years subsequent to 1985, when it is obvious that due to such factors as net operating losses it might well have been anticipating a much lower effective tax rate.

4. Changes Affecting International Taxation. The President's plan proposes to make numerous changes in the rules governing the taxation of overseas

operations. Among the major items of concern to NAM members are the proposals (a) to restrict use of the foreign tax credit by providing for mandatory use of the "per country" limitation; (b) to change substantially the present rules for determining the source of sales income; (c) to alter significantly the rules on the allocation of interest expense; and (d) to repeal the possessions tax credit.

Although all of the items mentioned are of significant concern to us, the first is of such large magnitude and broad applicability as to warrant additional discussion. The President's plan proposes to replace the present "overall" foreign tax credit limitation with a "per country" limitation. The proposal would also add new rules for allocating and recapturing losses in foreign countries and would make numerous other technical changes in the foreign tax credit rules.

Under the proposal, the amount of income tax paid to a foreign country that could be claimed as a foreign tax credit would be limited to the U.S. tax on income from that country. Thus, if the foreign country's tax rate exceeds the U.S. rate, which is likely to be a frequent occurrence if the U.S. rate is lowered to 33%, a credit for the excess would not be available under the proposed tax reform plan. Under present law, on the other hand, in determining the applicable foreign tax credit limitation the taxpayer aggregates income earned in and income taxes paid to all foreign countries. This in effect permits the averaging out of foreign tax rates, so that the taxpayer does not necessarily lose credits for taxes paid to countries with rates higher than the U.S., so long as that taxpayer also has income and pays taxes in countries with lower rates.

The alleged justification for changing to a per country limitation is that the current overall limitation causes economic decisions to be distorted purely for tax advantages and permits some countries to maintain high tax rates without reducing their ability to attract U.S. investments. NAM, however, believes the correct view is that the overall limitation effectively treats overseas business operations as an integrated whole. Such a view is consistent with the normal approach taken by businesses in investing abroad, which is to serve broad geographic markets through production, transportation and marketing facilities which may be located in a variety of different countries.

In addition, the existing overall limitation is far simpler to apply and administer than the proposed per country limitation. Under the overall method, all foreign income, expenses and taxes are aggregated. Under the per country method, all foreign income, expenses and taxes would have to be traced through the tiers and branches of corporations to their country of origin, thus imposing an extraordinary administrative burden on taxpayers and a comparable enforcement burden on the Internal Revenue Service.

NAM urges that Congress not adopt any of the Administration's proposed changes with regard to the foreign tax credit, the foreign income sourcing or allocation rules, and the possessions tax credit. We believe the net result of such changes would negatively affect the ability of U.S.-based multinational companies to operate competitively in world markets. Their adoption would serve only to further aggravate the international competitiveness problems which we see flowing from other aspects of the plan, most particularly the huge increases in taxes on capital investment.

B. Increased Complexity and Administrative Burdens. After the international competitiveness issue, which we think stands out as the paramount concern raised by the President's proposal, probably the next most worrisome issue is the extent to which the proposal will further complicate, rather than simplify, our tax laws. Two broad areas of concern are worthy of mention. One is the extent to which the plan would make further widespread changes in the tax treatment of employee benefits. This is an area of the law that has seemingly been under constant revision in recent years. In the last four years alone, significant alteration of the rules governing employee benefits have been enacted as part of the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Tax Reform Act of 1984 and the Retirement Equity Act of 1984.

This seemingly incessant stream of rule changes has seriously eroded employer confidence in the stability of the tax laws and has unnecessarily complicated the task of designing and maintaining attractive employee compensation packages. Even more significant, from the standpoint of a small manufacturer, are the excessive compliance costs associated with such constant changes. Unlike large employers, most small businesses simply do not have the internal staff resources to cope with such changes, and instead must rely on expensive outside consultants.

We foresee similar problems with respect to those changes in the President's plan relating to what could be broadly described as "tax accounting" issues. Included in this category would be such items as the proposed changes dealing with the proper measurement of income—and in particular issues relating to inventory valuation—and the proposed expansion of the corporate and individual minimum taxes. Here again, the compliance burden will fall most heavily on those smaller firms that will be forced to turn to outside legal and accounting firms for help. In assessing whether such increased burdens are justified, Congress among other things should take into account the fact that the anticipated revenue gain associated with a particular employee benefit or tax accounting rule change oftentimes is not very large.

Finally, in addition to the complexity/compliance issues, other special considerations apply in the case of employee benefits taxation. NAM believes that a soundly-designed tax policy should include provisions that encourage both private retirement savings and private sector provision of adequate health care coverage. A number of the changes in the President's seem to run counter to these goals. In particular, we find this to be true of the proposed changes in plan nondiscrimination and benefit distribution rules and of the proposal to eliminate Section 401(k) plans. We also fail to discern any policy justification for the regressive proposal to tax employer-paid health coverage up to a specified dollar amount.

C. Adverse Macroeconomic Implications. NAM is greatly troubled by the adverse marcroeconomic implications of the President's tax reform plan. Our major concerns in this regard are summarized below:

1. Cost of Capital; Productivity; Growth. The President's plan would significantly raise the cost of capital for producer durables, leading to a marked decline in business fixed investment relative to current law. A higher cost of capital also will induce the substitution of labor for capital, leading to a decline in the capital-labor ratio and lower productivity. Another likely effect is a shift in economic activity to labor-intensive sectors and away from capital-intensive sectors. In essence, the President's plan would induce a moderate "deindustrialization" of the U.S. economy, characterized by a continuing loss of domestic jobs in manufacturing. As to the overall effect of the plan on growth, it has been estimated that, relative to current law, the plan could result in a loss of as much as four or five points of GNP growth in 1987. Simply stated, the $260 billion tax increase on capital over the plan's first five years is too large, too abrupt, and too narrowly focused to be healthy for the economy.

2. Trade Effects. The President's plan will exacerbate an already serious trade deficit in manufactured goods ($89 billion in 1984). This result will flow fairly directly from the ITC repeal and the ACRS repeal and recapture rules, which mainly impact on goods-producing sectors. Many U.S.-based companies in these sectors are already experiencing severe difficulties in competing with foreign-produced goods in both domestic and international markets. For these companies, the President's plan will engender productivity declines that will

further weaken their ability to meet competitive pressures in a world economy. Additional restrictions in the international taxation area will further undermine the ability of American-based multinationals to compete effectively in overseas markets. An inevitable by-product of the foregoing will be an acceleration of the tendency to locate new production facilities—and the jobs that go with them—outside the U.S.

3. System Biases. While the President's plan purports to achieve a more neutral tax system, it is most decidedly not neutral as between the taxation of individuals and the taxation of corporations, nor is it neutral with respect to its treatment of income and consumption.

Over the period 1986-90, the plan would raise net corporate income taxes by more than $125 billion, in order to "finance" politically attractive rate reductions for individuals. This, however, would only further skew a distribution of federal income tax liabilities that is already heavily weighted against business taxpayers. In any given year, the government takes from 25% to 35% of total corporate profits through the income tax system, while taking only 10% to 12% of total personal income. Moreover, these figures do not include social insurance contributions such as FICA and FUTA taxes, more than half of which are paid by employers.

Another unfortunate aspect of the President's proposal is that it would compound the existing bias of the U.S. tax system in favor of consumption and against income. The U.S. already derives a higher share of its revenues from taxing income from work, savings and investment and a lower share from taxing consumption than any other major industrialized nation. A systematic reform of the tax system should attempt to correct this bias rather than perpetuate and increase it. Among other things, additional encouragement of consumption will further heighten the demand for imports.

IV. Conclusions

At this time, NAM neither supports not opposes the President's tax reform plan as a whole. We believe, however, that the President's goal of reforming and simplifying our nation's tax laws deserves prompt and serious legislative consideration. To this end, we will be pleased to work with the Congress and the Administration to make the President's plan a better one.

A major criterion for judging any plan which ultimately emerges from the legislative process is whether it will favorably or adversely affect the ability of American manufacturing firms to compete in a world economy. NAM urges the Congress not to adopt any set of reform proposals that would have the net effect of making U.S.-based manufacturers less competitive in either domestic or overseas markets. We concur in the observation, already voiced by the Secretary of the Treasury, that the competitive difficulties now being faced by American companies can often be traced to non-tax factors such as labor costs, exchange rates, etc. This, however, in no way justifies the enactment of changes in the tax laws that would further exacerbate such difficulties.

Based on this criterion, a few major recommendations are in order. First, the ACRS recapture tax proposal should be dropped completely. Next, Congress should consider retention of the present capital recovery system (ACRS plus ITC) or a variation thereof. If, however, it is decided instead to replace such system, the Congress should strive to design a replacement system that approximates the present value of expensing for machinery and equipment. None of the proposed changes in the foreign source income area should be adopted.

The inevitable question that arises is how to replace the revenue lost by making the suggested changes. That is not an easy question to answer. One thing, however, is clear. Individual tax reductions at any cost should not be the driving goal of reform, particularly reductions that encourage consumption rather than savings or investment; it is in fact possible to pay too high a price for such rate reduction. Thus, no matter how desirable some aspects of the President's plan may appear, the Congress must consider other approaches in lieu of resorting to sudden and excessive increases in business taxes, especially taxes on capital. One available technique is to take a bold conceptual leap beyond the four corners of the income tax system and consider a broad-based tax on consumption.

Such a tax would have a number of major advantages. First, it would permit the reform process to proceed without requiring counterproductive increases in the taxation of capital. Such a tax also would help mitigate the bias of the present federal tax system in favor of consumption and against income from work, savings and investment. It could and should be designed so that it applies to imports into the U.S. but not to exports from the U.S. This latter feature would not only improve our international trade competitiveness but also might help abate the pressure for Congressional enactment of protectionist trade measures.

This concludes my prepared statement. I would be glad to address any questions which members of the Committee may have.

APPENDIX A

Consumption Taxation

The key to lowering deficits must be reductions in the growth of federal spending across the board. If, however, Congress decides to increase federal tax revenues as part of a deficit reduction program including comparable or greater reductions in the growth of federal expenditures, such an increase should be accomplished through a consumption-based tax.

Attempts to increase income tax revenues through a multitude of patchwork changes, as has been the practice in the past, will only further complicate a tax system which already is excessively complex; moreover, such changes can only lead to further erosion of the important capital formation incentives that are available under present law. A massive overhaul of the existing income tax structure—by greatly expanding the tax base through broadened definitions of income and extensive repeal of existing deductions and credits—is not only politically difficult but also would very likely exacerbate the existing bias in our tax system favoring consumption at the expense of savings and investment.

A consumption-based tax should be designed in accordance with the following principles:

1. It should apply on a transaction basis, *e.g.*, it should be imposed on an *ad valorem* basis when a taxable product or service changes hands. Indirect taxation of consumption, for instance by a "consumed income" type of tax that provides unlimited deductions for net savings and investment, is theoretically attractive and meets a desirable goal: the stimulation of increased capital formation. For the present, however, such an approach is impractical due to the many definitional, transitional and political problems it would raise.

2. It should apply to the broadest possible base of taxable goods and services, so as to spread its burden equitably across the entire economy, while at the same time permitting the tax rate to be as low as possible given the amount of revenue intended to be raised. Omission of the service sector from the tax base would be unfair, requiring higher rates on a narrower base and impacting more heavily on those groups that consume more goods than services.

3. It should apply to the full value of covered goods and services, up to and including retail value, and should be separately stated and readily identifiable. Transaction-based tax systems that omit the retail level will necessarily result in an undesirable narrowing of the tax base.

4. It should include appropriate adjustments to mitigate its impact on low income individuals.

5. If it is paid at multiple points in the distribution process, appropriate credits for such prior payments must be allowed to prevent the pyramiding of taxes upon taxes.

Revenues from a transaction based-consumption tax should be used in part to replace revenues from the existing income tax system, thus reducing the government's excessive reliance on the taxation of individual and corporate income, permitting a general lowering of income tax rates and facilitating the process of tax reform and simplification. Revenues not so used should be dedicated solely to deficit reduction. 10-5-84.

APPENDIX B

TABLE 1

COMPARISON OF ACRS/ITC WITH CCRS WITH RESPECT TO A $1000 INVESTMENT

	Inflation Rate		
Present Value of Deductions*	10%	5%	0%
ACRS 3-year property (no ITC)	$ 865	$ 908	$ 957
ACRS 3-year property (with ITC)	969	1011	1058
CCRS - Class 1	955	954	953
ACRS 5-year property (no ITC)	766	837	922
ACRS 5-year property (with ITC)	945	1012	1093
CCRS - Class 2	940	940	939
CCRS - Class 3	920	920	919
CCRS - Class 4	891	890	889
CCRS - Class 5	853	853	853

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* Source: Statement of Ernest S. Christian before this Committee; June 13, 1984, pages 8-9. Present values are computed using a 4.0% real rate of return, which converts to a discount rate of 4% with no inflation, 9.2% with 5% inflation, and 14.4% with 10% inflation. These present values are overstated because they treat the first year's tax benefit as occurring immediately rather than at the subsequent estimated tax payment dates. Deduction value of ITC is determined at a 46% tax rate. Figures reflect basis adjustment.

STATEMENT OF ROBERT S. McINTYRE, DIRECTOR OF FEDERAL TAX POLICY, CITIZENS FOR TAX JUSTICE, WASHINGTON, DC

Mr. McIntyre. Thank you, Mr. Chairman. I appreciate the chance to be here today on behalf of Citizens for Tax Justice. Through our member organizations, we represent some 20 million American taxpayers who have an important stake in a fairer and economically more sensible tax system.

The question we have been asked to address today is: Will tax reform be good for the economy? Of course, the answer to this question depends largely on how tax reform is defined.

Traditionally, reform has meant asking everyone to pay their fair share of taxes, and that is certainly what the President is talking about in his speeches. We strongly support this kind of reform. We think it would be good for the tax system and good for the economy as well, because it would rid the economy of investment-distorting loopholes that only waste our resources.

On the other hand, the term "tax reform" has also been picked up and used by others who have a very different agenda. They want to continue the shift in the tax burden away from those with the most ability to pay taxes and onto those with less. Unfortunately, that is the version of tax reform that the President has included in his actual proposals. We think this kind of "reform" would be bad for the tax system and bad for the economy.

Unlike some of the witnesses you will hear today, we are not here to ask that our members be exempted from taxation or that they be granted huge tax cuts. Instead, we are only asking that you give us a tax system that returns to basic principles of fairness and basic principles of economics commonsense.

As I am sure the members of the committee have heard over the last months, notably in two recent studies, the level of tax avoidance by the Nation's major corporations and many upper income individuals has gotten totally out of hand. A study we recently completed found that almost half the 275 large profitable corporations we examined managed to pay nothing in Federal income taxes in at least 1 of the 4 years of President Reagan's first term. Representative Pickle on the House side has had the Treasury Department put together data showing that there are 30,000 individuals making over a quarter of a million dollars each who pay little or no Federal income taxes.

The reasons for this kind of tax avoidance are clear. In fact, it is the same loopholes in both cases—accelerated depreciation, investment credits, capital gains, oil and gas tax breaks and so forth. All are put together either by corporate accountants or by tax shelter promoters to allow major companies and upper income individuals in many cases to avoid paying their fair share of taxes. And as a result, the fairness of our tax system has been largely undermined. And that is not the only damage the loopholes have caused.

You will hear from many interest group lobbyists telling you that we need to retain special tax preferences for this and that because, if we don't have those things, America will stop working; that we will stop building houses; we will stop drilling for oil; we will stop planting trees; and that our international competitiveness will somehow disappear. These kinds of claims are particularly ironic in light of our current economic situation. Back in 1981, the loophole lobbyists were given virtually everything they asked for when it came to special "incentives." Yet, since then, our trade deficit has ballooned so that we have now become a debtor nation. The unemployment rate has stayed at levels that would previously have been considered intolerable. We have had a weak growth in investment over the 4 years. And, in general, we have had a very poor economic performance.

We think that, not only have the tax incentives failed to help the economy, they have actively hurt the economy, first of all, by making an enormous contribution to the budget deficit. In fact, corporate loopholes alone, unless they are checked, will add over $680 billion to the Federal deficit over the next 5 years. In addition, besides the deficit, the loopholes have distorted economic activity away from what the market says makes sense and what consumers want to buy and into areas that are invested in only because of "tax welfare" subsidies.

Regrettably, the President's program does not solve this problem. In fact, in many cases it makes it worse by increasing depreciation writeoffs and retaining many other tax breaks that distort economic activity and undermine fairness.

At the end of our written testimony, we suggest a number of ways we think that the President's program could be amended to make it actually do the job that the American people are crying out be done. Many of our proposals are consistent with what the Ways and Means Committee is now considering. We hope that, when and if Ways and Means passes a bill, this committee will be able to take that bill, and, in conjunction with the House, fashion a real tax reform measure that delivers what most Americans want: a fair tax system that makes economic sense. Thank you.

Senator BAUCUS. Thank you.

[The prepared written statement of Mr. McIntyre follows:]

CTJ

Citizens for Tax Justice

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Statement of Robert S. McIntyre
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Before the Senate Committee on Finance
Concerning the Impact of Tax Reform
On American Business Generally
October 2, 1985

I appreciate the invitation to appear before the Committee today on behalf of Citizens for Tax Justice. Our coalition of public interest, labor, and grassroots citizens groups represents tens of millions of average American taxpayers who have a vital stake in restoring fairness and economic common sense to our nation's tax laws.

The Committee has asked the witnesses today to discuss "the projected effect that tax reform will have on American business generally." In other words, the question we are addressing is: will tax reform be good for the United States economy? The answer to this question depends, of course, upon what is meant by "tax reform."

One kind of reform--which we believe would be tremendously beneficial to the economy--is reflected in the speeches President Reagan is giving around the country. In those speeches, the President calls for an end to the tax loopholes that allow large-scale tax avoidance by major corporations and wealthy individuals and that, at the same time, severely damage the economy. This kind of tax overhaul is what most people have in mind when they speak of reform, and it enjoys widespread popular support. Polls show overwhelming public agreement, for example, that corporations "pay too little in federal income taxes" and that "the rich tend to get out of paying income taxes by using accountants and lawyers."

The term "tax reform" has been appropriated, however, by those with a quite different agenda. This second type of "reform" is reflected in the President's actual tax proposals, which drastically conflict with the President's rhetorical pronouncements. This version of "reform" entails a continuation of the shift in the tax burden away from those most able to pay taxes, and it calls for retention or even expansion of many of the tax preferences that promote tax avoidance and impede economic growth. We strongly oppose this kind of so-called "reform."

In our view, real tax reform means, first of all, a return to basic principles of tax fairness. Moreover, we are convinced that a more equitable tax system will go hand in hand with improved economic growth. In this testimony, I will outline the scope of the current tax avoidance problem, discuss the serious economic damage that tax loopholes are causing, explain the fundamental shortcomings of the President's tax proposals, and recommend some basic steps we believe need to be taken to produce a truly fair, economically sensible federal tax code.

Tax Avoidance By Major Corporations and Upper-Income Individuals:

On August 29, Citizens for Tax Justice released a detailed study of the domestic profits and federal income taxes of 275 major, profitable American corporations over the 1981-84 period. Our report, *Corporate Taxpayers and Corporate Freeloaders*, includes a number of startling findings. For starters, 129 of the companies we examined--or almost half--managed to pay nothing in federal income taxes, or to receive outright tax rebates, in at least one of the four years we examined. These 129 companies earned $66.5 billion in pretax domestic profits in the years they did not pay federal income taxes. But instead of paying $30.6 billion in income taxes, as the 46 percent statutory corporate tax rate supposedly requires, they received $6.4 billion in tax *rebates*--for a "negative" tax rate of -9.6 percent.

Totalling up taxes and rebates for the full four years, we found that fifty of the 275 companies paid an overall total of nothing or less in federal income taxes over the entire 1981-84 period. Despite $56.8 billion in pretax domestic profits, these 50 companies received net tax *rebates* totalling $2.4 billion.

As a group, the 275 companies paid an overall four-year effective tax rate of only 15 percent, less than one-third of the 46 percent tax rate that the tax code purportedly requires major corporations to pay. Had these 275 companies paid the full 46 percent rate on their $400.6 billion in 1981-84 profits, their taxes would have totalled $184.3 billion--or $124 billion *more* than they actually paid.

Of course, our group of 275 corporations is only a representative sample of all companies. According to the staff of the Joint Committee on Taxation, the *total* cost of "corporate tax expenditures" will reach $119.9 billion in fiscal year 1986. This $119.9 billion in corporate tax subsidies represents well over half the estimated federal budget deficit for fiscal 1986. It adds up to $1,512 each for every taxpaying family and single individual in America.

In fact, the corporate income tax has reached such a sorry state that it is now more loophole than tax. The estimated cost of corporate tax breaks in fiscal 1986 amounts to $1.69 for every dollar corporations are expected to pay in federal income taxes.

How do so many companies manage to pay so little in federal income taxes? The two most important factors are the Accelerated Cost Recovery System adopted in 1981 and the investment tax credit. Together, these two tax preferences are expected to cost the Treasury a staggering $384 billion over the next five years unless they are curtailed.

In addition, a number of industries enjoy tax breaks tailored specifically for them. The oil industry, with immediate write-offs for the "intangible drilling costs" of drilling wells and percentage depletion for all but the major companies, is a well-known example. Timber companies are allowed to treat much of their profits as lightly taxed "capital gains"--a loophole that helps all but wipe out income taxes for the paper industry. And defense contractors achieve their extremely low tax payments largely through a tax preference called "completed contract accounting." All told, the Joint Committee on Taxation estimates that corporate "tax expenditures" will amount to $689 billion between 1986 and 1990 unless the laws are changed.

Without doubt the critical factor in producing today's widespread corporate tax avoidance (and the growth in personal tax shelters as well) was the enactment of President Reagan's "Economic Recovery Tax Act of 1981." The Accelerated Cost Recovery

System included in that bill dramatically changed the way in which businesses write off--or depreciate--their investments in machines and buildings. Together with the investment tax credit, ACRS produces effective tax rates on the profits from new investments in equipment that are actually negative! In other words, after-tax profits generated by such investments actually exceed pretax profits. These "negative rates" are the primary cause of the extremely low corporate taxes revealed by the CTJ study and the similar reports issued by the Joint Committee on Taxation for Representatives Dorgan and Pease of the House Ways and Means Committee.

For example:

- In 1984, AT&T enjoyed $332 million in investment tax credits and $682 million in "deferred taxes" relating to accelerated depreciation--enough to cut its 1984 federal income tax rate from the statutory 46 percent to *minus* 12.7%.

- General Electric, through its regular business activities and its leasing subsidiary, General Electric Credit Corporation, generated $1.1 billion worth of investment tax credits and accelerated depreciation write-offs in 1984, and thereby reduced its effective tax rate to only 6.2 percent.

- Pacific Gas & Electric Co. used $109 million in investment tax credits and $114 million worth of ACRS write-offs to help slash its 1984 federal income tax bill to a *negative* $12.6 million--despite pretax profits of almost $1.5 billion.

- Union Pacific saved $279 million in taxes using accelerated depreciation and another $64 million from the investment tax credit, to reduce its 1984 tax rate to just 5.2 percent.

- Pepsico used accelerated depreciation write-offs and investment tax credits--many of them purchased through "leasing" arrangements--to receive $135.8 million in net tax *refunds* over the 1981-84 period, despite $1.8 billion in pretax domestic profits.

Tax avoidance is not limited to the corporate sector, however. In addition, many upper-income individuals are able to manipulate the tax laws to escape personal income taxes. The scope of the problem is documented in a recent study undertaken by the Treasury Department at the request of Rep. J.J. Pickle, Chairman of the Ways and Means Subcommittee on Oversight. According to the Treasury data, nearly 30,000 households with "total positive incomes" of $250,000 or more a year--or 11 percent of such households--paid federal income taxes totalling less than 5 percent of their incomes in 1983. More than 3,000 households where incomes exceeded $1 *million* a year paid less than 5 percent of that income to the IRS in 1983.

The Pickle report reveals that this large-scale tax avoidance by the extremely rich is traceable to the same loopholes that have undermined the corporate income tax. The proliferation of tax shelters, particularly in real estate and oil and gas, has been nothing short of stupendous. The Pickle report found that tax "losses" from real estate partnerships had ballooned from $6.5 billion in 1975 to $23.0 billion in 1982. This increase of more than 250 percent can be directly linked to the huge increase in depreciation write-offs provided by the 1981 tax act's corporate tax cut provisions. "Losses" from oil and gas partnerships climbed from $1.7 billion to $13.2 billion over the same time period, reflecting the spread of the tax-shelter mentality the 1981 policies encouraged.

Running for Shelter, published by Public Citizen in February of this year, details how the growth in tax shelters has far outpaced virtually every other form of investment in recent years. From 1976 to 1983, the dollar volume of public tax shelter offerings grew at an average rate of more than 50 percent per year, and the number of new public shelter offerings increased yearly by an average of 22 percent. Meanwhile, for example, new business incorporations increased by only 2.7 percent a year. In 1976, the dollar amount of public shelter offerings equalled only 11 percent of new common stock issues. But in the 1980s, the dollar amount invested in public shelters has grown to well over half the amount invested in new common stock issues.

The Pickle study found that wealthy taxpayers paying little or no income taxes used tax shelter "losses" to reduce their 1983 taxable incomes by 67 percent. It also pointed to the major loophole that cuts taxes for the very well-off generally: the special tax treatment for capital gains. For the entire group of individuals earning more than $250,000, capital gains tax breaks reduced income subject to tax in 1983 by an average of 23.2 percent. According to the Joint Committee on Taxation, the capital gains exclusion currently saves individuals with incomes greater than $200,000 a staggering $53,000 each every year.

The Economic Harm From Loopholes

Needless to say, the loopholes that make massive tax avoidance possible did not enter the tax code by accident. And, as this year's tax reform debate continues, Congress is being besieged by loophole lobbyists claiming that taking their clients off "tax welfare" would produce disastrous consequences for America. Without tax subsidies, you are being told, American companies will stop investing in new machines and buildings, stop drilling for oil, and stop harvesting or planting timber. Various real estate interests maintain that tax reform would make it impossible for most Americans either to own or to rent a place to live, implying that the United States would become a nation of tent dwellers. Venture capital lobbyists claim that capital gains tax breaks are essential to encourage "risky" investments. And, over and over again, you are being told that America's international competitive position hangs in the balance, with loopholes the key to our ability to compete with foreign goods.

Such claims are incredible in and of themselves, but they are especially ironic in light of the current economic situation. In 1981, the business lobbying groups were given virtually everything they had ever dreamed of in terms of tax loopholes. Yet, since then, we have seen one of the weakest performances in plant and equipment investment in postwar history. Despite a mini-boom in capital spending in 1984, over President Reagan's first term, real business investment in plant and equipment increased at an average annual rate of only 3 percent--less than half the rate of increase in the previous four years. We have experienced the highest sustained rate of unemployment since the 1930s. And we have watched our position in world trade deteriorate so badly that we have become a debtor nation for the first time in 80 years.

The truth is that tax "incentives" have been a terrible failure when measured against their ostensible goals. CTJ's own study of the reaction of individual corporations to the 1981-enacted "incentives" over the 1981-83 period (*The Failure of Corporate Tax Incentives*, released earlier this year) found that the 50 lowest-taxed companies of the 238 we surveyed actually *reduced* their capital spending by 22 percent, while the companies paying the highest taxes augmented their capital investment the most.

Today, with corporate cash flow at record levels, business capital spending is going nowhere. Instead, that cash flow has helped produce: a record wave of mergers and acquisitions, totalling well over $300 billion during President Reagan's first term; corporate purchases--or repurchases--of common stock at a rate of $75 billion a year; and extremely strong dividend payouts, with the ratio of dividends to after-tax profits growing to 62 percent in 1985, up from 55 percent last year.

Nor, despite the fervent claims of the loophole lobbyists, have capital gains breaks played any significant role in the venture capital boom that began in 1980. To the contrary, a recent Congressional Budget Office report specifically refutes such contentions. In fact, the key factors behind the increase in venture capital investment were a rapid surge in demand for high-technology electronic products following the end of the 1974-75 recession, followed by a large influx of venture capital by tax-exempt pension funds.[1]

But tax loopholes have not merely been ineffective as an economic tool. They have, in fact, caused serious damage to our economy. Corporate loopholes are now costing the federal government $120 billion a year, plus the tens of billions of dollars a year in individual tax-shelter revenue losses that these same tax preferences produce. This staggering cost is among the principal causes of the federal government's seemingly interminable budget deficits, which, in turn, have bid up real interest rates--driving up the value of the dollar and helping produce our skyrocketing trade deficits.

This growing trade gap has crippled the manufacturing sector of the U.S. economy. Since 1979, 1.7 million jobs have been lost in manufacturing, including 220,000 just in the first half of this year. The national unemployment rate has remained at 7 percent or higher--a level that previously would have been considered intolerable.

Even a good part of the increased capital investment associated with the recovery from the 1981-82 recession has benefitted overseas equipment and machinery suppliers. The import share of capital spending has nearly doubled since 1980, representing nearly one-quarter of all purchases today.

And the budget deficit is not the only damage that loopholes have caused. In addition, the vast differences in tax rates among industries and among specific companies--as revealed by CTJ's recent report and in similar studies by the staff of the Joint Committee on Taxation--and the shift into tax-motivated, tax shelter investments is creating serious distortions in the nation's economic activity.

CTJ's report found that effective tax rates by industry vary from "negative" effective rates for the airlines and financial companies covered by our survey, to rates in excess of 32 percent for leisure and personal care companies, textile firms, and tobacco companies. Corporations producing computers and office equipment and automotive companies on average pay six times the tax rate of paper companies and aerospace firms.

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[1] In part because of 1979 changes allowing pension plans to engage in "riskier" investments, a remarkable 59 percent of the increase in venture capital between 1978 (when the top capital gains rate was reduced) and 1984 was supplied by pension funds, other tax-exempt entities, and foreigners. Another 28 percent came from corporations, such as life insurance companies and banks, many of which already paid little or nothing in taxes and which, in any event, were not significantly affected by the 1978 capital gains changes. A mere 13 percent of the increased venture capital came from individual investors. In other words, the venture capital boom was overwhelmingly dominated by organisations for which the 1978 capital gains cut was largely or totally irrelevant.

Moreover, even within industries, tax rates vary widely. For example, in the electrical equipment and appliances sector, ITT, Harris Corp., Singer Co., and General Electric all received net tax *rebates* between 1981 and 1984, while Raytheon Co. and Whirlpool Corp. paid more than 40 percent of their profits in federal income taxes.

Such disparities in effective tax rates among industries and among companies that must compete with one another are inconsistent with the basic principles of free enterprise. This back-door-- and seemingly random--version of industrial policy imposes great costs on the American economy, costs that are exacerbated by the problems that personal tax shelter investments create. Our tax system distorts economic choices by artificially boosting the rate of return on investment dollars in preferred industries and reducing the rate of return in those industries which are less-favored. As a result, the flow of capital tends to shift in favor of those industries and companies that have been most successful in the political marketplace of Washington, D.C.

In most cases, it should be noted, the impact of tax "incentives" is swamped by the market forces of supply and demand. Indeed, that is exactly what many of the low-tax, low-investment companies covered in CTJ's study, *The Failure of Corporate Tax Incentives*, explicitly reported. W.R. Grace & Co., for example, despite $684.1 million in pretax domestic profits between 1981 and 1983, actually made $12.5 million off the tax system over that period by selling its excess tax breaks. At the same time, it reduced its level of capital investment by 15.8 percent in 1982 and by another 37 percent in 1983. In its 1983 annual report, the company explained that the cut in capital spending was made in "response to the reduced demand" for its products. Similarly, Tenneco cited "the weakness in natural gas demand" to explain its 31.8 percent drop in investment between 1981 and 1983, despite its use of tax "incentives" to pay no federal income taxes on $2.7 billion in domestic profits and claim an extra $189 million in tax rebates over that period.

But when tax loopholes do "succeed" in affecting behavior, that "success" means they have encouraged a shift into investments that make no economic sense in the absence of a tax subsidy. And so we see tax shelters diverting individual investment dollars into activities such as llama breeding, foreign stamps, already-built shopping centers, empty office buildings, and even a $485 million shelter in used billboards. We see a shift in corporate investment away from long-lived machines and industrial plants, and into short-term, tax-favored assets. Such a policy of encouraging projects that make no sense at the expense of otherwise useful investments is, as the Treasury Department put it last November, fundamentally "irrational."

The time has come to face up to the fact that the experiment with a loophole-based economic strategy has been a flop. America is not a better place because of tax avoidance, and American companies do not compete better abroad because they earn tax-sheltered profits at home. To the contrary, by diverting resources away from their most productive uses and adding to federal budget deficits, the loopholes undermine our ability to compete. Indeed, the very manufacturing industries that were supposed to have been the beneficiaries of tax preferences have actually been the ones most hurt. If America is to sustain and strengthen its economy and its international competitive position, it is imperative that we remove the distortions and irrationalities from our tax code.

The Reagan Program

Despite the President's populist-sounding rhetoric, the tax program he has presented to Congress does not deliver the real tax reform that the country so sorely needs. Although the President does propose repeal of several important tax-avoidance loopholes, notably the investment tax credit, his plan is centered on curtailing widely used tax provisions such as the deduction for state and local taxes, which many tax analysts think is a sensible adjustment in a fair tax system and which, in any event, has nothing to do with the problem of tax shelters.

In fact, the President's program would actually enlarge some key tax-shelter preferences, including enhanced accelerated depreciation write-offs and a reduced top tax rate on capital gains.

As a result, the supposed corporate tax increase in the administration's tax program is only a short-term aberration. The reality, according to the Congressional Budget Office, is that the President's proposal would "probably provide a corporate tax reduction over time."

Nor does the President's plan put a serious dent into upper-income tax avoidance. To the contrary, the program would produce enormous tax reductions for the richest Americans--the same ones whose taxes were already so substantially cut by the President's 1981 tax legislation. According to the Joint Committee on Taxation, the administration tax plan would be worth an average of $23,253 per year each to families with incomes exceeding $200,000.

In addition, while there has been much debate over whether the President's tax program is "revenue-neutral" over the next five years, there can be little dispute that it involves large long-term revenue losses. Such added federal revenue shortfalls would exacerbate our international trade problems and almost inevitably lead to increased pressure for a super-regressive national sales tax in the future.

What Needs To Be Done

What most people want from tax reform is the assurance that everyone--not just them--is paying a fair share of taxes. What the economy needs from tax reform is an end to the revenue-draining, investment-distorting preferences that waste our resources. Regrettably, the program the President has presented to Congress does not achieve these results.

There is a better way. The following pages outline a number of loophole-closing amendments to the President's program that, taken together, provide the groundwork for a truly fair, economically sensible tax system. The proposals described here also would produce the revenues needed to provide real tax and deficit relief for average Americans.

1. A Depreciation System That Makes Sense:

Under current law, the way that the tax laws take account of business capital expenditures is a mess--a mess that undermines both tax fairness and economic growth. Even with a 46% statutory corporate tax rate, the Accelerated Cost Recovery System of depreciation, in conjunction with the investment tax credit, produces "negative" tax rates for most categories of equipment.[3] Because of this system of negative rates, many major companies are able to pay little or nothing in federal income taxes and

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[2] This is true even for equity financed investments. Where investments are financed with borrowed money, even structures can enjoy "negative" tax rates under ACRS.

individual tax shelters have proliferated wildly. In addition, effective tax rates vary widely among different industries and different kinds of investments, leading to huge distortions in investment decisionmaking and inefficient uses of capital.

Recognizing that the current capital recovery system is tremendously harmful, both the Bradley-Gephardt "Fair Tax" plan and the tax program put forward by the Treasury Department last November proposed to repeal ACRS and the investment tax credit and replace them with a system that requires businesses and investors to write off their investments in equipment and buildings for tax purposes about as fast as they actually wear out. So large is the current system of subsidies that the Treasury estimated that repeal of ACRS alone would raise $213 billion between 1986 and 1990.

Unfortunately, the program that the President presented to the Congress in May turns its back on the effort to bring rationality to business depreciation. Commendably, the President's plan does include repeal of the investment tax credit. But the administration concedes that its proposed "Capital Cost Recovery System" for depreciation is actually *more* generous than the current ACRS approach.

The Joint Committee on Taxation staff has estimated that the depreciation changes proposed by the President would raise $21.6 billion between 1986 and 1990 compared to current law. By the early 1990s, however, the Congressional Budget Office projects that the Reagan depreciation plan would *lose* money. By the year 2010, those losses could reach $70-80 billion a year compared to the current ACRS approach.

To deal with this fundamental problem in the administration's tax program, we recommend following the lead of the Bradley-Gephardt "Fair Tax" and Treasury's November program and designing a tax depreciation based on the way buildings and machines actually wear out. We have worked out a specific approach, which involves a literal blending of Treasury I's "Real Cost Recovery System" and the "Simplified Cost Recovery" approach included in the Bradley-Gephardt Fair Tax bill.

Under our proposal, there would be 7 classes of depreciable assets. These are the same classes as in Treasury I, which is said to be based on the latest research on how assets actually wear out. (The Bradley-Gephardt plan provides 6 classes.) The depreciation rates also would be based on the economic depreciation rates proposed by the Treasury in November.

Instead of indexing depreciation deductions for inflation, as the Treasury's November program entailed, our proposal's depreciation allowances would be based on a 175%-declining-balance, "open-accounts" system. What this means, for example, is that Class 1 assets (i.e., automobiles), with an economic depreciation rate of 32% per year, would be written off at 175% time 32%, or 56% a year. Under the open-accounts approach, taxpayers would no longer need to keep track of depreciable properties on an asset-by-asset basis. Instead, new purchases would simply be added to the total for the class, and the appropriate percentage would be multiplied by the undepreciated balance.

The 175% declining balance rate was chosen so that depreciation write-offs would reflect economic reality at current inflation rates.[3] As it turns out, depreciation allowances under our proposal would be very similar to those in the Bradley-Gephardt bill (which also uses a declining balance, open-accounts system).

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[3] Should inflation accelerate or decelerate significantly in the future, it would be simple for Congress to adjust depreciation write-offs by changing the declining balance rate to a higher or lower figure.

Assuming, for example, a 33% statutory tax rate and a 5% inflation rate, our proposal produces the following results compared to the President's program, Treasury I and Bradley-Gephardt:

	Prop.	Reagan	Treas. I	Bradley-Gephardt
Class 1:				
Depreciation Rate:	56%	55%I	32%I	62%
Effective Tax Rate:	*31%*	*17%*	*26%*	*28%*
Class 2:				
Depreciation Rate:	42%	44%I	24%I	42%
Effective Tax Rate:	*34%*	*18%*	*29%*	*34%*
Class 3:				
Depreciation Rate:	32%	33%I	18%I	25%
Effective Tax Rate:	*32%*	*17%*	*28%*	*37%*
Class 4:				
Depreciation Rate:	21%	22%I	12%I	25%
Effective Tax Rate:	*34%*	*17%*	*30%*	*31%*
Class 5:				
Depreciation Rate:	14%	17%I	8%I	14%
Effective Tax Rate:	*33%*	*17%*	*24%*	*33%*
Class 6:				
Depreciation Rate:	9%	17%I	5%I	9%
Effective Tax Rate:	*33%*	*13%*	*29%*	*32%*
Class 7:				
Depreciation Rate:	5%	4%I	3%I	6%
Effective Tax Rate:	*35%*	*25%*	*32%*	*33%*

As can be seen, the approach we suggest produces effective tax rates that are virtually identical to the assumed 33% statutory tax rate for all classes of assets--and it also will do the same for any statutory tax rate that is chosen. (The Bradley-Gephardt and Treasury I plans do almost as well in this respect.) The President's proposed "Capital Cost Recovery System," on the other hand, produces effective rates of only about half the statutory rate, and thereby would provide continued opportunities for interest arbitrage.[4]

In contrast to the President's CCRS depreciation plan, which raises only $21.6 billion between 1986 and 1990 and loses huge amounts in the long run, our depreciation proposal would raise between $65 and $110 billion compared to current law over the

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[4] While profits generated by depreciable property would be taxed at only about 17% under the President's program, interest would be deductible at a 33% marginal rate. As a result, tax shelters based on this differential will continue to proliferate.

1986-90 period, and would continue to raise money over the long term. By the year 2010, it could raise in excess of $80 billion a year.[5]

Compared to ACRS with a 33% corporate rate and no investment credit, our depreciation proposal is about the same for class 1 assets, slightly more generous for class 2 assets, and somewhat less generous for assets in classes 3 through 7. Also compared to ACRS, our proposed depreciation system should raise money in all asset classes, except class 2, in both the short and the long runs. Its revenue pick-up appears to be similar to that under the Bradley- Gephardt plan.

2. Capital gains:

Until 1969, the maximum tax rate on capital gains income was 25%. The maximum rate went up in the 1970s (generally to a maximum of 35%, and in theory to a high of 49%), but was cut back to 28% in the 1978 tax act. The 1981 Reagan tax act reduced the top capital gains rate still further, to only 20%.

The top tax rate on capital gains is a function of both the maximum personal tax rate on ordinary income and the exclusion, if any, that is allowed for capital gains income. Thus, current law's top capital gains rate of 20% reflects a 50% maximum personal tax rate and a 60% capital gains exclusion. The President's new program, by dropping the maximum personal tax rate to 35% and retaining a 50% exclusion for capital gains, would produce a top capital gains rate of 17.5%.

The special treatment of capital gains is a primary source of complexity and unfairness in the tax code. The wealthiest class of taxpayers--those with annual incomes in excess of $200,000--manage to style close to 40 percent of their income as capital gains, and thereby save a staggering $53,000 each in taxes every year. (In contrast, the average benefit from the capital gains exclusion for taxpayers earning below $50,000 is $49 a year.) Over half of the benefits of the capital gains exclusion go to individuals with incomes greater than $200,000, and two-thirds of the benefits go to those earning more than $100,000.

As noted earlier in this testimony, we find the economic arguments for special treatment for capital gains to be unsupported by the evidence. But, even if one were somehow to find economic magic in 1978's cut in the top capital gains rate to 28%, that provides no justification to reduce the rate to only 17.5%. We recommend, therefore, that the exclusion allowed for capital gains be no higher than 30%. With a top personal rate of 35%, as the President has proposed, this would produce a maximum capital gains rate of 24.5%--still well below 1978's supposedly critical figure and less than the 25% marginal rate proposed by the President for middle-income taxpayers on their wages, dividends, and interest income. Should Congress decide to make the top personal tax rate 40%, the Proposal's 30 percent exclusion would produce a top capital gains rate of 28%--exactly the same as under the 1978 legislation.

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[5] Over the 1986-90 period, the proposed depreciation system would appear to raise about three time as much as the President's depreciation plan and a little over half as much as the Treasury's November depreciation program. The staff of the Joint Committee on Taxation has estimated that the President's depreciation changes would raise $21.6 billion over the 1986-90 period. (This is considerably lower than the administration's projection of $38 billion.) The Treasury Department estimated that its November proposal would have raised $213 billion betwen 1986 and 1990. Thus, the wide range of revenue estimates presented here. Note: These estimates are very tentative and are subject to very substantial revision.

A 30 percent capital gains exclusion would raise an additional $31 billion over the 1986-90 period compared to the President's program (before taking account of the rate reductions). Most of this added revenue would come from the best off taxpayers--those whose taxes were already reduced so substantially by the 1981 tax reduction act. In fact, reducing the exclusion to 30% would appear to scale back the President's proposed $30 billion tax cut for taxpayers earning more than $200,000 over the 1986-90 period by more than half.

3. Oil & gas:

One of the primary symbols of the unfairness of the current tax system is the special treatment of oil and gas income. Not only do oil and gas preferences allow many "independent" oil corporations and some giant major companies to pay little or nothing in federal income taxes, but the tax breaks also breed tax-shelter opportunities for upper-income individual taxpayers. In 1982, for example, oil and gas partnerships reported $13.2 billion in tax "losses"--making oil and gas second only to real estate as a tax-shelter vehicle.

In addition, the oil and gas tax breaks provide a perverse incentive to use up America's limited energy supplies--what some have called a "Drain America First" energy policy--and they discourage the development of alternative sources of energy.

Despite these notorious defects in current law, the administration's program would retain many of the oil loopholes. We believe this needs to be corrected. As under both Treasury's November tax plan and the Bradley-Gephardt "Fair Tax," we re commend the repeal of percentage depletion in favor of cost depletion and an end to the immediate deductibility of intangible drilling costs. This change would raise about $40 billion over the 1986-90 period compared to the President's program, and would significantly curtail upper-income tax avoidance based on oil and gas tax shelters.

4. International Issues:

A major issue facing the United States today is our enormous deficit in international trade. There are many causes for the current situation, most notably the over-valued U.S. dollar (which most experts attribute to the high real interest rates that the federal budget deficit has helped produce). But the current rules governing the taxation of international profits earned by American multinational corporations also share at least some of the blame. In many cases, these tax laws can provide substantial incentives for American companies to export manufacturing facilities and jobs to low-tax foreign countries, at the expense of production and jobs in the United States.

One of the most fundamental problems is called "deferral." It allows profits earned by foreign subsidiaries of U.S. companies to be exempt from U.S. taxation until those profits are brought back into the United States. In addition, under current law, the way the "foreign tax credit" is computed can allow foreign taxes paid to high-tax foreign countries to be used to shelter profits earned in low-tax foreign countries from U.S. taxation. Finally, companies often can treat expenses of earning foreign profits as deductions from their domestic taxable income--providing a further incentive to set up operations abroad.

The Reagan tax plan proposes to make some important changes in the taxation of international profits, primarily involving the computation of the foreign tax credit and the rules governing the sourcing of deductions. But the Reagan plan fails to address the basic issue of deferral of taxes on profits earned abroad. Repeal of deferral would solve most sourcing problems, eliminate much of the complexity in international taxation that leads to abuses, and reduce many of the problems in the foreign tax credit area in a relatively simple and straightforward manner.

We therefore recommend that you follow the lead of the Bradley-Gephardt "Fair Tax" and repeal deferral. This change would raise several billion dollars over the 1986-90 period, while removing artificial incentives for American companies to move their plants overseas.

5. Corporate Tax Rate & Depreciation Recapture:

The administration proposes a sharp reduction in the statutory tax rate on large corporations--from 46% to 33%. Because this dramatic cut will create windfalls for companies that "deferred" taxes in the past under various tax preferences, the administration also proposes to "recapture" some of those previously deferred taxes. Specifically, the administration wants to "recapture" some of the taxes deferred due to excess depreciation deductions taken under ACRS over the 1981-85 period.

The depreciation recapture provision has been criticized both for doing too much and for doing too little. In fact, although recapture make some theoretical sense, it is difficult to understand why the administration has singled out depreciation for special treatment--other than its need for revenue to offset its tax rate reductions. (The recapture provision solves the administration's revenue problem only in the short run.)

One straightforward way to minimize the need for a recapture provision is not to cut the corporate rate as dramatically as the administration has proposed. This is the approach we suggest. We recommend that the corporate rate be reduced to no lower than 39% rather than 33%, and that the depreciation recapture provision be dropped.

The 39% rate was chosen, first, to balance the revenue loss that abandoning depreciation recapture entails. The two changes together would not significantly affect revenues between 1986 and 1990 compared to the President's program. (There would be a substantial long-term revenue pick-up, however, which would help offset the administration plan's large long-term revenue *loss*.) In addition, a top corporate rate of 39% would be consistent with both the administration's proposed top personal tax rate and a higher top personal rate (e.g., 40%), which we believe Congress should consider. It is important to keep the corporate tax rate close to, or higher than, the level of the top personal tax rate so that top-bracket individuals do not attempt to use corporations as tax shelters for their investment income.

6. Tax Shelters:

No matter how good a job Congress does in reforming the tax laws, anomalies will almost certainly remain--anomalies that will give birth to new tax shelter schemes, perhaps yet undreamed of. To prevent abuses in the future, we recommend two approaches: First, a "schedular" limit on the use of tax losses by individuals; and, second, a corporate minimum tax based on "book" profits.

As the Pickle report reveals, upper-income taxpayers often use tax-shelter "losses" to avoid paying taxes on their dividends, interest, and wages. Under the "schedular" approach to tax losses that we recommend, this kind of tax sheltering would no longer be possible. The schedular system, utilized by a number of U.S. states and by many foreign countries, is a simple idea. It simply says that tax "losses" generated on one tax schedule, e.g., Schedule K (partnership income) or Schedule E (rents and royalties), can only be used to a limited extent to offset income reported elsewhere. Thus, an individual with $500,000 in wages and interest income could not use "losses" generated from a real estate partnership to avoid paying taxes on his or her wages, dividends, and interest. It could be appropriate to adopt an aggregate schedular limit on "losses" of $10,000, so that only taxpayers with very significant tax losses would be affected.[6]

The corporate minimum tax we recommend would provide an alternative minimum tax of 25 percent of "book" income--i.e., the income that corporations report to their shareholders. It would effectively limit the ability of publicly-traded companies to report one (high) profit figure to their stockholders and another (low) figure to the IRS. This consistency requirement is similar to the approach used in Japan, where book income forms the basis for corporate taxable income (subject to limitations on abuses). The 25% rate--the same as the marginal tax rate the administration proposes for middle-income individuals--reflects the minimum amount that large corporations ought to be expected to contribute to support the nation's government.

Conclusion

We estimate that the recommendations made above would raise between $130 and $175 billion over the 1986-90 period compared to the President's plan. These added revenues could be used to provide further tax relief to middle-income families, to cut the federal budget deficit, or for other changes in the President's tax program that Congress finds appropriate.

Our proposals would not simply raise revenues, however. They also would improve market-based economic incentives by curbing artificial, tax-induced distortions, and would thereby contribute substantially to long-term economic growth. They would avoid the substantial long-term revenue losses that the President's program entails. And most important, they would produce a far more equitable tax system than under the President's program, assuring that those with the most ability to pay taxes contribute their fair share. A fair tax system is what the public is demanding from tax reform. We are counting on the Congress to deliver it.

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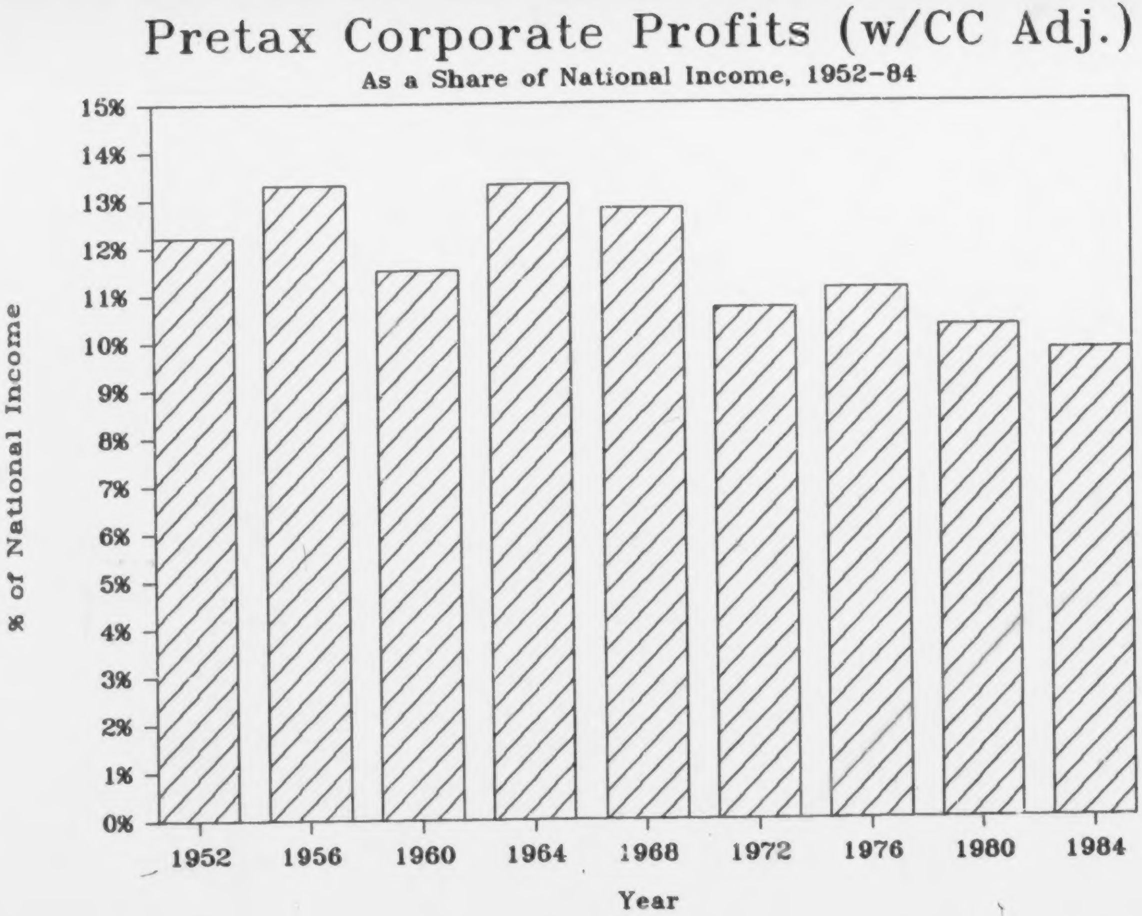
[6] For example, a small farmer with a regular wage-paying job as well would not be affected by the proposal, even if his or her farming business lost as much as $10,000 in a given year. But a "tax-shelter farmer," attempting to offset very large amounts of regular income with farm "losses," would be affected.


Pretax Corporate Profits (w/CC Adj.)
As a Share of National Income, 1952–84
% of National Income
15%
14%
13%
12%
11%
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
1952
1956
1960
1964
1968
1972
1976
1980
1984
Year

Senator BAUCUS. Senator Long.

Senator LONG. I have no questions to ask.

Senator BAUCUS. I have a few questions for the panel. First, a question basically to you, Mr. McIntyre: You made somewhat light of the concern that our international competitive position might be declining and that these proposals, whether the President's or the Ways and Means draft could worsen that problem, by shifting additional taxes to American business. My question is: Does it make sense at a time when our trade deficit is so high and when American business is faced with great international competitive challenge to pass a tax bill that shifts the burden of taxation away from individuals to business?

Mr. MCINTYRE. Senator, I did not make light of the trade situation. In fact, we take it very seriously, since many of our members are directly harmed by the export-import imbalance. When we recommend that you fashion a tax system that gets rid of the subsidies for inefficient behavior, we do so in part because we firmly believe that such a change will indeed help our trade situation. Let me explain why. Obviously, the biggest issue affecting trade is the Federal budget deficit, which has led to high real interest rates and then to our overvalued dollar. But in addition, insofar as American business becomes more efficient, it will be able to compete better. The international comparison that is most apt here is with the Japanese, who have a tax system—which we designed for them back in the early 1950's and with which they have basically stuck—that includes very few tax loopholes. Their corporate tax expenditure budget comes to about 2 cents for every dollar paid in corporate taxes, compared to ours, which is now $1.69 for every dollar paid in corporate taxes. They manage to raise close to 30 percent of their Government revenues from corporate income taxes and they have faired very well. Because their system makes the process and the company that is the most efficient win, in contrast to a system like ours, which subsidizes inefficiency.

Senator BAUCUS. The problem with that is that it is hard to compare the United States and Japan solely with regard to taxation since Japan engages in other practices to help business. For example, they don't have a Glass-Steagall Act; this makes it easier for banks to have an equity position in business and so makes interest rates lower for those companies. There is some evidence that the Japanese system provides a lower cost of capital.

Mr. MCINTYRE. I agree, Senator, but——

Senator BAUCUS. So, the question is: What do we do in the meantime? There are American businesses going down the tubes. Sure, the Japanese tax structure is different from ours, but the Japanese have engaged in other practices which help their companies. These would take a long time for this country to adopt if we ever adopted them. That is a basic policy question, the degree to which we want to be like Japan. In the meantime, with a lot of companies suffering, I wonder if it makes sense to shift more of the burden onto business.

Mr. MCINTYRE. Senator, companies that are not making money in international trade now—and there certainly are many of them—will get no benefits from tax-subsidized profits because they don't have profits to subsidize. So, if you do want to give some kind of export assistance to American firms, doing it through the Income Tax Code just won't work. If a company or an industry is not making any money, you can't subsidize those nonexistent profits through the Income Tax Code. United States Steel, for example, has tax credits coming out of its ears, but those tax breaks aren't doing it any good because the company doesn't make any money. And that is true in general with American companies that are in trouble; they are very difficult to help through the Federal Income Tax Code. What you end up doing is giving the money to companies that are successful and that don't need it and building up the deficit and hurting those very companies that you are trying to help.

Senator BAUCUS. I would like to ask all of you a question. To what degree should we use the Code to stimulate and encourage higher private savings rates or discourage consumption? For example, some suggest expanding IRA's and Keoghs, and at the same time limiting the deductibility of consumer interest expense?

Mr. McINTYRE. I don't think it should be used that way, Senator.

Senator BAUCUS. Dr. Rahn.

Dr. RAHN. The Tax Code ought to be neutral between savings and consumption. Right now, savings is taxed at least twice more than consumption; and we need to eliminate that bias by expansion of 401K's, IRA's, other types of savings exclusions, lower capital gains taxes and the like. They would all do that.

Senator BAUCUS. All right. Mr. Huard.

Mr. HUARD. I would agree that the tax system ought to be used to strike a better balance between the taxation of savings and income and the taxation of consumption. If you look right now at the distribution of Federal receipts, you will see that the Government gets about 93 cents on the dollar from the total of the two income taxes and the FICA, or payroll taxes. That is taxing income from work, savings, and investment. You get maybe five cents on the dollar from taxing consumption through miscellaneous excise taxes, and that is just a ridiculous balance which is probably—well, it is the lowest of any industrialized country.

Senator BAUCUS. Mr. McIntyre.

Mr. McINTYRE. Senator, two comments here. First of all, we think that moving toward a consumption tax would be a terrible mistake. But even if you did want to stimulate savings, doing it through the kinds of income tax loopholes that were discussed just a second ago simply doesn't work.

Senator BAUCUS. That is not my question. My question is: Should we try in the Code to encourage savings?

Mr. McINTYRE. That is what I am getting at, Senator. The attempts so far to encourage savings through the Income Tax Code—whether by IRA's or Keogh plans or 401K's—have been totally unsuccessful. If anything, the savings rate has fallen since these provisions were adopted. Now, that is not totally happenstance. In fact, economists can show you that tax incentives, so-called, for savings can actually lead to less savings because people don't need to save so much to meet their retirement goals. It is quite clear that many people do respond that way. If you are planning, for example, to have $30,000 a year to live on when you retire from the Senate, and I tell you that you can achieve that goal by saving

$5,000 a year, whereas previously it took you $8,000 a year in savings to reach your goal, then it would be quite rational on your part—and quite likely—that you will save less. And in fact, we see that response from many people in real life.

Senator **Baucus**. Now, can you answer my underlying question? The question is: Should the code be used to stimulate more savings?

Mr. **McIntyre**. You won't be able to use the code to stimulate more savings, Senator, because it won't work. You will just succeed in——

Senator **Baucus**. The answer is no?

Mr. **McIntyre**. Yes.

Senator **Baucus**. All right. Thank you.

Mr. **McIntyre**. That is what I said at the beginning.

Senator **Baucus**. Senator Long.

Senator **Long**. I will be reading all three of your statements. I regret that I was delayed getting here because I had to attend a meeting of the Democratic Senators about the fiscal situation in which we find ourselves. Senator Grassley.

Senator **Grassley**. My first question would be to Mr. Huard. You stated your belief that the current level of taxation on income was too high and that taxation consumption was insufficient. What sort of consumption tax do you or would you advocate, in view of the need for more of an emphasis on consumption?

Mr. **Huard**. I think you ought to have some kind of system which is as simple and as broad-based as possible. Now, there are two ways to tax consumption. One is the so-called consumed income tax, or cash flow expenditure tax, where you add up your income and you subtract out your net savings and investment. And that is a very fine theoretical idea, but in practice, the transitional problems and the definitional problems are just enormous; and I frankly would regard it as impractical, which means if you are going to effectively tax consumption, you will probably need a transaction-based type of tax, such as the VAT or retail sales tax.

Senator **Grassley**. At this point, is your organization supporting such a broad-based consumption tax?

Mr. **Huard**. If properly designed, we would support such a tax. We have a board resolution that says we would.

Senator **Grassley**. Are you in a position of advocating such a consumption tax as part of this tax reform proposal?

Mr. **Huard**. That depends on how it would fit into the puzzle, if you will. If it would basically fit into the puzzle, then——

Senator **Grassley**. But at least, you aren't taking initiative in that area?

Mr. **Huard**. Oh, no. What we are recommending is that Congress look at shifting toward taxing consumption. We are not recommending any specific degree, any specific method. What we are saying is: Instead of taxing capital, you ought to look at taxing consumption.

Senator **Grassley**. All right. Dr. Rahn, I missed your testimony, but I know that you spoke to the fact that the country has never been more ready for some sweeping changes in the tax system. Now, my impression of the Midwest, from the mail I receive and the people I talk to when I go home every weekend, people are either ambivalent or more concerned with deficit reduction. And so, I guess I would ask for an explanation on where you perceive the groundswell of support for tax reform coming from.

Dr. RAHN. A survey of the American public had shown that they felt the income tax system was unfair. It had a lot of distortions in it. But I have to agree with you, from talking to many of your colleagues, both in the Senate and in the House, and with our own members, we are not finding much of a groundswell these days for tax reform. I think part of the dilemma is that the Congress has boxed themselves in when they have talked about tax reform because of this charade of static revenue neutrality. In all other aspects of human life, we agree that changes in prices affect our behavior, that the law of supply and demand does work, but when it comes to tax reform and we have static revenue neutrality. That is essentially saying that supply and demand does not work for changes in taxes. As a result, you, by definition, have to have virtually as many losers as winners with any kind of tax bill that is built on this nonsense of static revenue neutrality. The losers, of course, always scream louder than the winners. That is who you hear from; that is who we hear from. And if I could make one basic suggestion to you, it is that the Congress and the administration get away from this nonsense of static revenue neutrality because you come up with the wrong numbers which leads you to the wrong policy decisions.

For instance, in our own testimony there, we did some very conservative estimates of the changes just on the individual rates. We know from the previous history of tax changes—the Coolidge tax changes in 1920, the Kennedy rate cuts, the cuts you all made in 1981—that when you reduce the high marginal rates, you strictly don't have any revenue loss. Many times you have a revenue gain, but when you reduce low marginal rates, you do have substantial revenue losses. That is logically to be expected. That ought to be factored in correctly, and then you will get a very different number. So, you have greatly overestimated the loss when individual rate changes. At the same time, you greatly overestimated the gain from the changes in depreciation because there is again an assumption that there is no behaviorial change on the part of business firms. We know that just plain isn't true. I could go on and on, but I would encourage you to get away from static revenue neutrality.

Senator GRASSLEY. Let me ask you how that relates to my question of whether or not there is a groundswell out there. You are saying that if we change our method of computing income from tax reform, it will be a little more politically palatable and there will be more of an interest out there at the grassroots level for the tax reform?

Dr. RAHN. Yes, because what would happen is that, if you have proper tax reform, you would have higher economic growth than you otherwise would have. And if you have higher economic growth, you will get additional tax revenues from that economic growth. So, you can indeed lower rates for more people and still increase revenues, if you have a properly constructed tax reform system; but in the absence of the proper definitions, you have again as many losers as winners; and hence, you have no groundswell for change because people don't want to go through the anxiety if they don't think they are going to be any better off.

Senator **Grassley**. I would like to ask the same question of you that I did of Mr. Huard: Whether or not the chamber supports any sort of consumption tax?

Dr. **Rahn**. We have been looking at a number of the alternatives--the business transfer tax, the VAT, and so forth—and as these proposals get more flushed out, our tax committee over the next month will be looking at them. I think our biggest concern, however, is that many of these proposals seem like they are adding on another layer of taxation, rather than being a real substitute for some of the less efficient taxes we now have. People are talking about abolishing the corporate tax structures we now have and substituting something else; I think we would take a look at that in a very serious way, or if we knew that total taxation would be limited through a constitutional amendment. But I think many of our members are fearful that, if we come up with a consumption tax, that would be just be added on to all the other taxes we take; and people will be worse off, rather than better off.

Senator **Grassley**. I would like to ask a question that would refer to page 59 of your testimony, table 18, Federal tax burden on corporations, the middle column: Corporate income tax receipts as percent of total Federal revenues. We see that to be 29 percent in 1959, 13 percent when this administration took over, 9 percent today. Do you have any sort of philosophical view, Dr. Rahn, Mr. Huard, and also Mr. McIntyre, on what that figure ought to be? Now, the administration through this bill, it is my understanding, is trying to move that back up a little bit; right?

Dr. **Rahn**. I will give you a philosophical statement. The figure ought to be zero. The corporate tax is one of the most inefficient taxes that has ever been devised. We don't know where the incidence of it is. Economists debate this.

Senator **Grassley**. Besides the philosophical answer, let's consider the practical politics. I asked for philosophical—that is all right—but the practical aspect of it, what do you see wrong in an upturn of that, if that is going to be the outcome of the administration's proposal?

Dr. **Rahn**. Under the tax changes you made in 1981 and 1982, because of the way the depreciation was set up, you will be getting a much bigger increase in the percentage of total taxes from corporations because of the way the depreciation changes are made. Again, the corporate income tax, though, since it falls on consumers in terms of higher prices and workers in lower wages and misallocates capital, is just not a very good tax; and we ought to look at a real substitute or just the abolition of it.

Mr. **Huard**. I certainly don't think the figure should go up any. I think, as I commented in my oral remarks before you arrived, Senator, that if you look at the big picture and you add in the Federal income taxes, States taxes, and most particularly payroll taxes, especially the FICA tax which just keeps growing and growing, you will find that the corporate tax burden has, in fact, been steadily rising and that if you add up all those figures, it now comes to about 80 percent of corporate profits.

Dr. **Rahn**. Can I say one thing, Senator Grassley?

Senator **Grassley**. Surely.

Dr. **Rahn**. The percentage of total corporate income as a share of GNP has declined at a very rapid rate over the last 30 years, and that explains much of it, also.

Senator **Grassley**. Are you referring, then, to the first column in table 18?

Dr. **Rahn**. In terms of percentage of GNP, you will see it in the fourth column. It went from 14 down to 6 percent.

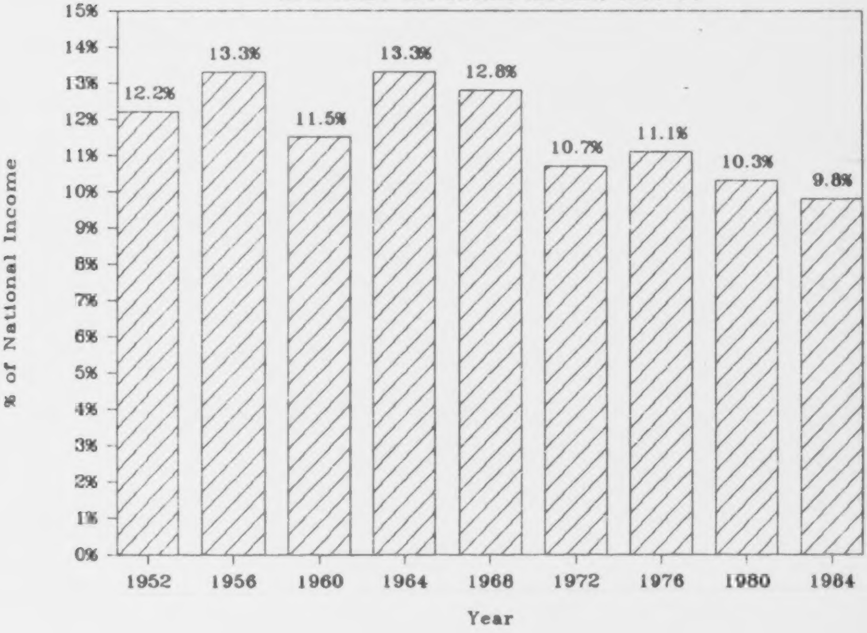
Senator **Grassley**. Mr. McIntyre.

Mr. **McIntyre**. Senator, let me make several points. First, let me respond to your question. Yes, we do think the corporate share of the tax burden should be increased and very substantially, as a matter of fact. It has declined very rapidly in the last few years, and that decline is the main source of our Federal budget deficit. And the loopholes that have undermined the corporate tax are also the main source of upper income individual tax avoidance. The tax shelters that the rich are able to use in many cases to avoid taxes are based on the same tax preferences that General Electric and Boeing and the other corporate tax avoiders use. If you are serious about restoring fairness to the personal side of the Tax Code, you have got to close those loopholes that also allow corporate tax avoidance.

Let me just briefly respond to a couple of the comments made by my fellow panelists. First of all, both the Joint Committee on Taxation and our group, Citizens for Tax Justice, have done studies of the average effective corporate tax rate; and it is approximately 15 to 16 percent, not 80 percent, as has been suggested. Second, Dr. Rahn's testimony claims that corporate profits as a share of the gross national product have declined precipitously and that this is the reason why corporate taxes have gone down. Unfortunately, the figures he uses are based on corporate taxable income rather than actual profits. When you adjust for overdepreciation, you find that corporate profits haven't declined as a share of the GNP very much at all. If I could, I would like to supply two graphs for the record so that you will have those figures.

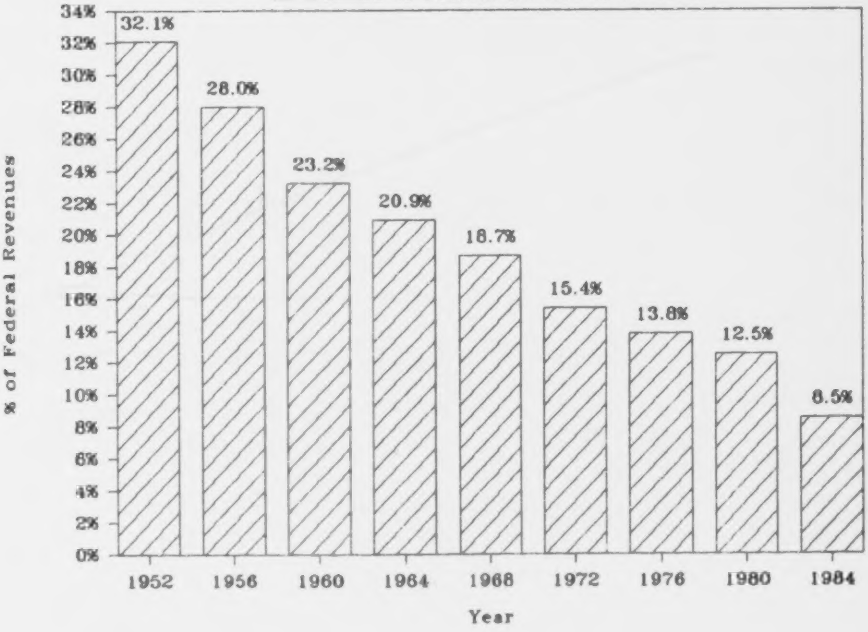
Senator **Grassley**. I will receive them. I will let the chairman make a determination as to whether or not they are a part of the printed record because I don't know what our rules are on that.

[The prepared tables follow:]



Pretax Corporate Profits (w/CC Adj.)

As a Share of National Income, 1952-84



Corporate Income Taxes

As a Share of Federal Revenues, 1952-84

Senator GRASSLEY. Does Senator Baucus have any questions of this panel?

Senator BAUCUS. Yes, I do.

Senator GRASSLEY. Go ahead, Senator.

Senator BAUCUS. Thank you, Senator. Gentlemen, and particularly Mr. Huard and Dr. Rahn, if a corporation is making *x* profits in any given year, why shouldn't it pay *y* percent in corporate income taxes? This is a question I am sure a lot of Americans are asking. They believe that a corporation making *x* billion dollars, should that corporation pay a certain percent in corporate income taxes.

Dr. RAHN. I think there is a fundamental misconception here.

Senator BAUCUS. Let me add something for you to address in your response, please. The underlying assumption of my question is: If we are going to encourage Americans' belief in the system, in Government and in the cohesiveness in our system of Government here, there has to be some belief that the laws are being administered fairly. This basically is a fairness and equity question. My question has very little to do with economic growth.

Dr. RAHN. But the fundamental concept is that only people can pay taxes. All taxes fall on individuals at some point. A corporation does not pay taxes. It is a tax collector for the Government. The question then with the corporate tax is: Which people pay that tax? Again, is it consumers in terms of higher prices? Is it workers in terms of lower wages? Does it go to stockholders and force them to invest elsewhere? And because we don't know the incidence of the corporate tax, it becomes an inefficient tax. It clearly misallocates capital, and it does lead to lower economic growth. And if we got rid of that nonsense that the corporation pays tax—it is tax collector. And if we are going to say that a corporation pays tax, then we ought to add up all these taxes that Paul Huard just talked about—State and local income taxes, property taxes, and all the other things a corporation collects for the Government; but it makes no economic sense to look at it that way. Also, just one correction of Mr. McIntyre's comments that the corporation tax—or a reduction of the corporation tax receipts is responsible for the deficit. That is absolute nonsense. The total Federal tax receipts as a percentage of the GNP has been fairly constant for the last 20 years. The problem clearly is excessive spending. The spending or the deficit problem is not going to be corrected by any types of tax changes. If you make a big tax increase, you will slow down economic growth; and the deficits will get worse, not better. We have shown that time and time again. And if we want to do something about the deficits, there is only one way to do it, and that is through the control of spending growth, not through the Tax Code.

Senator BAUCUS. Do you have anything to add, Mr. Huard?

Mr. HUARD. Two things. One of the difficulties in answering your question, of course, is the difficulty of determining what a profit is. A respectable case could be made that if you are going to tax corporations at all, and I could argue at length that you shouldn't tax them at all, at best you should tax them on cash-flow net of expenditures. Everything they spend ought to be deductible, including capital expenses. For instance, why rationally does a corporation which spends $3 million on advertising get to deduct that in the first year, but a corporation that spends $3 million on capital equipment gets to write it off over a period of years? There are, you know, esoteric accounting arguments you could make as to why that should take place or not take place. But I think one of the fundamental difficulties is determining profits. Also, I would like to amplify on Dr. Rahn's comments about the source of the deficit. I happen to remember the 1981 Tax Act. I happen to remember the distribution of the numbers—the projected $750 billion in revenue loss in the first 5 years of that act. Fully 80 percent was going to individuals, 20 percent to corporations. After we managed to get pummeled in TEFRA in 1982, that distribution changed to 90/10. So, I think if Mr. McIntyre is going to identify the 1981 act as the principal culprit of the deficit problem, he ought to acknowledge that the 90 cents on the dollar, flowing from the individual tax cuts, in the main source, not the corporate tax cuts.

Senator BAUCUS. I am unclear as to why then it really matters what the corporate tax rate is. Dr. Rahn, you said that corporations are not people but just tax collectors. They pass the tax onto others, in product prices, lower wages, or some combination. That raises a question: Does it really matter? I also ask the question because I know that the Japanese corporate tax rate is much higher than ours. There is a strong case made by some people that you don't hurt economic growth by taxing corporations because corporations do pass on the tax burden and because it is passed on, it does not have a direct bearing on business competitiveness.

Dr. RAHN. In many ways, you are right, but the key question is: What is the cost of capital? Japanese companies have a lower cost of capital than in the United States even though some of their corporate rates are slightly higher than those we face. But they exempt most saving from taxation. And the problem is that, in our country, we have the multiple layers of taxation of savings as opposed to consumption; and the corporate tax—much of it—impacts on savings and the cost of capital, so you get less investment here than you would in Japan because our cost of capital is higher.

Senator BAUCUS. Could you stay on that point? Why are Japanese capital costs lower? Is it because of lower interest rates? Is it because savings are not taxed? Or is it because they have lower corporate tax rates?

Dr. RAHN. It is performance. The main thing is that most capital gains are not taxed at all in Japan. Most savings are not taxed at all in Japan. And in our country, again we have these multiple layers of tax on savings and investment. And every study that I have seen of the comparisons of the cost of capital between the United States and Japanese firms clearly shows the Japanese have a considerable advantage. There are a number of ways to run a tax system. You could have a tax system where you have a high corporate rate; but if you, at the same time, exempt the double taxation of dividends, capital gains, and much of the savings that went in, you could have a more efficient system. That is not what we have done.

Senator BAUCUS. Would you advocate that—higher corporate rates?

Dr. RAHN. Again, all these things are tradeoffs. It depends on how much you——

Senator **Baucus**. I am just trying to understand from the Chamber's point of view which direction we should go in writing a tax bill.

Dr. **Rahn**. The way we calculate these things on these tax bills: We look at the cost of capital. And if you have a series of tax changes, which cause a reduction in the cost of capital, then we tend to be in favor of it. If you have a series of tax changes, both individual and corporate, in the aggregate which increase the cost of capital, such as the Ways and Means staff provisions, that clearly will slow economic growth and lead to higher rates of poverty and unemployment; and hence, we oppose it.

Senator **Baucus**. Thank you. I have no more questions.

Senator **Grassley**. I don't have any more questions, but I thought that, since Senator Baucus had addressed his questions to the two of you, if Mr. McIntyre had any sort of comments he wanted to make in regard to the same issues, we would give him an opportunity to make them before I dismiss the panel.

Mr. **McIntyre**. Thank you, Senator. I appreciate that. Let me make a couple of comments about the corporate tax and who pays it. It has been alleged here that corporate income taxes may be passed through to consumers or passed back to wage-earners; and Senator Baucus asked if that is true, why do we see so much lobbying against the corporate tax? I think that is a very good question. The truth of the matter is that, as best anyone can tell, the corporate tax is paid by the companies and their shareholders. And that is why we see so much lobbying on the issue. If you look at, for example, the oil companies, you will find radically different income tax rates. Texaco gets refunds; Exxon pays close to 30 percent. But they don't charge different prices for the oil. They don't pay different wages to their workers. If that tax is being passed back at all, it is to the shareholders of the companies. To a significant degree, however, it is the companies themselves that bear the burden.

Second, Senator, having given me this opportunity, let me just say that Dr. Rahn said a number of things about Japan which don't square with the facts as I know them. The Japanese do have some savings incentives but they are very modest ones. They are smaller than our IRA plans. They will exempt up to about $500 a year put into a savings account. They exempt some capital gains, but not the most predominant kind over there, because they only exempt capital gains in publicly traded stocks. In fact, the Japanese tax system is not the anticonsumption vehicle that some people think it is. Ironically, Americans designed the Japanese tax system, patterned after the balanced tax system we enjoyed in the 1950's, which taxed income both from working and from capital. We are the ones who have moved toward only taxing income from wages, not the Japanese.

Senator **Grassley**. We thank each of you very much for your participation. Information from staff indicates that the meeting will be recessed until 10:45 a.m. because Senator Packwood will return at that time. Thank you very much.

[Whereupon, at 10:26 a.m., the hearing was recessed.]

AFTER RECESS

Senator SYMMS. Good morning. Senator Pryor and I are here, so we will carry forth. We appreciate the patience of the witnesses, and we thank all of the witnesses here. A number of conflicting items on the agendas of many of our colleagues have made it difficult to get a quorum here this morning.

The second panel will consist of Charles F. Zodrow, chairman and chief executive officer of Roadway Services from Akron, OH. He will be testifying on behalf of the American Trucking Association. William Laimbeer, president of Owens-Illinois Diversified Division, Owens-Illinois Corp. from Toledo, OH, will testify on behalf of the American Paper Institute. James Koontz, president and chief executive officer of Kingsbury Machine Tool Corp., Keene, NH, and chairman of the board of the National Machine Tool Builders' Association, will also testify. Mr. Zodrow, welcome to the committee; we look forward to hearing from you.

STATEMENT OF CHARLES F. ZODROW, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ROADWAY SERVICES, INC., AKRON, OH; ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATION, INC.

Mr. ZODROW. Thank you, Senator. I am Charles Zodrow, chairman of the board of Roadway Services, but I am appearing today as the chairman of the tax policy committee of the American Trucking Associations, which is the national trade association for the trucking industry. ATA is a national federation of some 50 State associations, 11 conferences of different segments of the industry, and over 3,200 motor carriers of all types.

ATA supports immediate changes in the corporate tax system to more nearly balance corporate tax rates among industries. The plan proposed by President Reagan will go far toward promoting corporate tax equity and fairness, and we urge Congress to adopt its major elements.

We make this recommendation even though changes contained in the President's proposal will adversely impact companies in the trucking industry. For example, the investment tax credit is very important to our industry. Its loss would be particularly painful since ours is an industry which must replace its operating equipment, that is its tractor and trailer fleets, so frequently. In fact, many companies in our industry will pay more tax if the credit is repealed, even with the rate cut, than under current law. The depreciation recapture proposal would also result in higher tax liabilities.

Nevertheless, these changes would be worth the cost if Congress enacts a reduction in the corporate rate to 33 percent, as the President has proposed. The corporate rate cut, the preservation of lesser rates for small and low-profit firms and the enactment of a dividend deduction are important in reducing the unfair burden now borne by the highly taxed industries, including the trucking industry.

The trucking industry, as you probably know, is already the highest taxed industry in America. According to the study performed last November by the staff of the Joint Committee on Taxation, the average effective Federal income tax rate for trucking in the 4 years 1980 to 1983 was 38.2 percent. This was more than double the all-industry average of about 18 percent and 16 times the average of the lowest taxed industry, the railroads, which had a 2.4-percent effective rate. In addition, as you know, the trucking industry pays enormous amounts for highway and fuel taxes at the Federal and the State levels.

Our support for tax reform rests on enactment of a top rate of 33 percent. We strongly urge Congress not to allow any compromise of this reduction for the purpose of funding special interest provisions, whether corporate or individual.

Another provision of major interest to our industry is depreciation reform. The current depreciation system of accelerated cost recovery with partial basis adjustment is actually less beneficial than pre-1981 law for assets that wear out rapidly, such as heavy trucks and tractors. In contrast, longer lived assets received an enormous benefit from the 1981 changes. The President's proposal helps restore a balance among asset types without the complexity of too many classes or overly long lives, and without destroying the incentive for investment in new assets.

We also wish to commend the 10-percent dividend deduction. In fact, we are disappointed that it has been reduced from the 50 percent that was contained in the original proposal and is being considered for further reduction in the Ways and Means Committee action recently taken. It is important to at least begin to address the problem of double taxation of corporate dividends and to recognize the disparity of treatment between equity and debt financing.

We were pleased to note the recent action by the Ways and Means Committee, suggesting elimination of the depreciation windfall proposal. There really is no windfall in our opinion. Investments have been made, and depreciation has been taken, in reliance on existing tax law by firms acting in good faith, and whose investments contributed to the economic recovery. Those firms would now bear the brunt of what is really a retroactive tax increase. We must object to that in principle. It would set a bad precedent with unfortunate implications for future investment planning.

So, on balance, we believe the President's proposal will be a good one for the long-term economy. The personal and corporate rate reductions, together with retention of adequate investment incentives provided through CCRS, will encourage growth and productivity. We believe that, for our industry as a whole, the pluses in the President's proposal outweigh the costly minuses. The proposal will level the disparity in effective tax rates as between the trucking industry and competing forms of transportation. Depreciation reform and repeal of targeted special interest provisions will help make the Tax Code more neutral with respect to economic decisions.

We believe tax burdens should be thoroughly distributed among industries. If the committee finds it impossible within the framework of the President's proposal to achieve tax reform that equalizes burdens directly, then consideration should be given to a corporate minimum tax that guarantees all business with real income will pay some tax. However, such a tax should not be a disguised surtax that adds to the tax burdens of firms already paying at a high rate, nor should it apply to economic as compared to accounting losses.

In sum, ATA strongly supports the President's plan and urges Congress to approve a bill that incorporates its fundamental elements of cutting the top corporate rate to 33 percent, revising depreciation, and reducing special provisions which have the effect of distorting economic decisionmaking. We are ready to help such a bill get enacted. We have encouraged members of ATA to get in touch with their Representatives and Senators, and we are seeking and continue to seek broad support among the various groups, the Tax Reform Action Coalition and the Coalition to Reduce High Effective Tax Rates. Thank you.

Senator SYMMS. Thank you very much. Mr. Laimbeer.

[The prepared written statement of Mr. Zodrow follows:]

Before the
UNITED STATES SENATE
COMMMITTEE ON FINANCE

Statement of the
AMERICAN TRUCKING ASSOCIATIONS, INC.

on

TAX REFORM

Charles F. Zodrow

I am Charles F. Zodrow, Chairman of Roadway Services, Inc., in Akron, Ohio. Today I am appearing on behalf of the American Trucking Associations, (ATA), for which I serve as Chairman of the Tax Policy Committee. ATA is the national federation of the trucking industry, comprising 51 state trucking associations, 11 conferences representing different segments of the industry, and over 3200 carriers. ATA represents every type and class of motor carrier -- for-hire and private, regulated and exempt.

SUMMARY

ATA supports immediate changes in the corporate tax system to more nearly balance corporate tax rates among industries. We believe the plan put forward last May by President Reagan will go far toward promoting corporate tax equity and fairness, and we urge Congress to adopt its major elements.

We make this recommendation even though many of the changes contained in the President's proposal could have an adverse impact on companies in the trucking industry. For example, the repeal of the investment tax credit would be particularly painful for an industry which must replace its fleet frequently. In fact, some companies in our industry might pay more if the tax credit is repealed, even with the rate cut, than under current law. The depreciation recapture proposal would also result in higher tax liabilities for many companies. Nevertheless, we believe tax reform would be worth the cost if Congress enacts a reduction in the top corporate rate to no more than 33 percent, as the President has proposed.

The corporate rate cut, along with preservation of lesser rates for small and low-profit firms and the enactment of a dividend deduction, is vital for reducing the unfairly high burden now borne by trucking and other highly taxed industries.

The trucking industry is the highest-taxed industry in America. According to the study released last November by the Joint Committee on Taxation at the request of Representatives Pease and Dorgan, the average effective federal income tax rate for trucking in 1980-83 was 38.2 percent. This was more than double the all-industry average of about 18 percent, and 16 times the average of the lowest taxed industry, railroads, which had a 2.4 percent rate. In addition, trucking pays an enormous amount in highway and fuel taxes at both federal and state levels.

MAJOR PROVISIONS OF INTEREST TO TRUCKING

Rate reductions. Our support for tax reform rests on the enactment of a top rate no higher than 33 percent. We urge the Congress not to allow any compromise of this rate reduction for the purpose of funding special-interest provisions, whether corporate or individual. Preservation of lower rates for small and low-profit companies, as the President proposes, is also appropriate.

Another important form of corporate rate reduction is the provision for deduction of 10 percent of dividends paid. Although this is a far cry from the 50 percent dividend deduction contained in the Treasury proposal last November, it is still worth retaining. Double taxation of corporate income is one of the most unfair distortions in our tax system. This provision is a good start on lessening that inequity.

Depreciation. The Administration proposes to create six asset classes in place of the present five, to apply a different pattern of deductions, and to index deductions for inflation. These changes, for both short- and long-lived property, provide more favorable treatment than under present law if inflation exceeds current rates, but not if inflation is negligible.

These changes are both appropriate and modestly beneficial to the trucking industry. The current depreciation system, of accelerated cost recovery with partial basis adjustment, is actually less beneficial than pre-1981 law for assets that wear out fast, such as heavy trucks and tractors. In contrast, longer-lived assets received an enormous benefit from the 1981 changes. We believe this proposal would produce more evenhanded treatment without destroying the incentive to invest in equipment and machinery.

Investment tax credit repeal. This is a costly provision for an industry like trucking that must replace its equipment every few years. Some trucking firms could actually have a higher tax bill under the combination of a 33 percent rate and no credit than they do now.

However, the industry and the economy as a whole will be better off under a system that levies approximately the same tax rate on all income. The investment tax credit has been one of the major reasons effective rates differ so much among companies and among industries. Provided the revenue from repeal of the credit is used to reduce the corporate rate to 33 percent or below, we are prepared to accept its repeal. We do urge the Congress to provide fair transition rules to permit firms that ordered equipment, but did not receive it by the time the repeal goes into effect, to use the credit.

"Windfall" tax on past depreciation. This provision would require all taxpayers to add up their actual depreciation from 1980 through mid-1986, subtract the depreciation that would have been allowed under the straight-line method over the lives prescribed for calculating earnings and profits, and include a fraction of the difference in income. In 1986 and 1987, 12 percent would be included in income; in 1988, 16 percent. (If the difference was less than $300,000, or if total actual depreciation was less than $400,000, none of it would be subject to tax.)

We are troubled by both the principle and the cost of this provision. There is no windfall. These investments have already been made and depreciation has been taken in reliance on existing tax law, by firms acting in good faith and whose investment contributed to the economic recovery. Now they will bear the brunt of what is really a retroactive tax increase. We object in principle to this aspect of the President's proposal, which to say the least would set a bad precedent with unfortunate implications for future investment planning.

We urge you to eliminate this ill-conceived provision, if that can be done without raising the corporate tax rate above 33 percent. At the very least, recapture must be modified to make it less unfair.

Complexity. We often hear that complexity is not a problem for corporate taxpayers because they can just "put it in the computer." The truth is that changes in law are often very costly to comply with. To put it in the computer correctly frequently requires enormous effort to understand the law, apply it to the firm's unique circumstances, and adapt it to the accounting system of the firm, computerized or not. Change and the uncertainty it brings can be expensive in upsetting corporate planning.

Therefore, we urge you to avoid making changes that add to complexity but do not significantly improve either fairness or revenue. For instance, the Administration proposal refers to the November Treasury plan for depreciation as a basis for calculating earnings and profits and the minimum tax. Yet that plan was never put in legislative language, and it had a different number of asset types from either current law or the current proposal. Such a change seems needlessly complex. So does the proposal for changing from a mid-year to a mid-month convention for depreciation. A further example of complexity is in the foreign tax credit proposals, which would affect some carriers, even though trucking is largely a domestic business.

Employee benefits issues. Several of the changes proposed in the taxation of compensation would affect many trucking firms. The most widespread is the proposal to include as income a portion of each month's health insurance premium ($10 for single coverage, $25 for family coverage). This would do nothing to control health insurance costs. It is also unclear whether these amounts give rise to additional social security tax liability. If so, both administrative expense and tax cost would be increased, a result we consider unfortunate.

We are troubled by the proposal added to the President's plan on August 31 to repeal section 401(k) deferred compensation plans. Many trucking companies have recently instituted these and find them very popular with employees. Two other benefits changes that would entail new accounting expenses for many employers in the trucking business are the requirement that all employee awards be included as income and the denial of deductibility for half the cost of business meals costing more than $25 per person. We urge you to consider carefully whether each of these changes is necessary. If you conclude they are, we ask they be designed to minimize the administrative burden of compliance.

Corporate minimum tax. We believe tax burdens should be fairly distributed among industries. If the Committee finds it impossible to achieve tax reform that equalizes burdens directly, consideration should be given to a corporate minimum tax that guarantees all businesses with real income pay some tax. However, a minimum tax should not be a disguised surtax that adds to the tax bill or compliance burden of firms already paying at a high rate. Nor should a minimum tax be levied on economic, as opposed to accounting losses.

CONCLUSION

On balance, the Administration's tax package will be beneficial for the economy and for the trucking industry. The economy will gain from the greater work, saving, and investment called forth by lower personal and corporate rates; by the retention of investment incentives, such as accelerated depreciation, dividend deductibility, and a capital gains exclusion; and by the repeal or restriction of uneconomic special provisions that distort investment decisions.

We believe that for the industry as a whole, the pluses in the President's proposal outweigh the costly minuses. Corporate rate reductions will bring down our excessive effective tax rates. Depreciation reform and repeal of targeted special interest provisions will help to make the tax code more neutral with respect to economic decisions. Future economic expansion will be market-based rather than driven by tax policy.

We have encouraged tax reform along the lines of this proposal as a founder of the Tax Reform Action Coalition, and as a member of the Coalition to Reduce High Effective Tax Rates.

Therefore, ATA strongly supports the Administration's plan and urges you to approve without delay a bill that incorporates its fundamental elements of capping the corporate rate at 33 percent or below, revising and indexing depreciation, and eliminating many special provisions. We recognize that some changes will be necessary for economic, technical, and perhaps political reasons. We stand ready to help members of both parties in that process, provided the basic principles above are maintained.

STATEMENT OF WILLIAM LAIMBEER, PRESIDENT, OWENS-ILLINOIS DIVERSIFIED DIVISION, OWENS-ILLINOIS CORP., TOLEDO, OH, ON BEHALF OF THE AMERICAN PAPER INSTITUTE, ACCOMPANIED BY NORMA PACE, SENIOR VICE PRESIDENT OF THE AMERICAN PAPER INSTITUTE

Mr. LAIMBEER. Thank you, Senator. My name is Bill Laimbeer, and I am president, diversified operations, Owens-Illinois, Inc., Toledo, OH, and with me is Norma Pace, senior vice president of the American Paper Institute. We are pleased to have this opportunity to comment on the proposed tax reform program on behalf of the American Paper Institute.

The industry produces a wide variety of paper and packaging products that are a significant part of our daily lives. Paper is part of America's growing standard of living. During the past 15 years, the demand for printing and writing papers advanced 3.4 percent a year, considerably faster than the GNP annual gain of 2.8 percent. Linerboard, an important packaging material, advanced 2.5 percent a year.

Heavy investments of equipment are required to produce a ton of paper, and the U.S. industry has maintained a fast pace of capital spending. During the 1969 to 1984 period, capital outlays increased 11 percent while dollar sales rose 9 percent. The industry will spend more than $8 billion on plant and equipment this year, in excess of 10 percent of sales. Although these investments have to be justified by market conditions, including international competition, the accelerated capital recovery system in the United States is helpful in facilitating the decisions. Changing the rules now will reduce capital outlays in the industry, hurt our international competitiveness, and retard growth.

The availability of tax incentives helps the industry maintain high levels of investments, even in periods of recession and reduced cash flow such as we experienced in 1981 and 1982. When one considers the highly volatile and postponable nature of a capital spending decision, the availability and flexibility of investment tax incentives contributes stability to the economy. It is for these reasons that we are particularly concerned with those parts of the tax reform proposals that affect capital formation. Specifically, these include recapture of the tax benefits obtained from the use of the accelerated recovery systems from 1980 through June 1985, replacement of the current investment tax credit and accelerated cost recovery system with a less favorable capital cost recovery system, removal of the investment tax credit on January 1, 1986, changes in foreign tax credits, capitalization of timber management expenses, and elimination of capital gains treatment of timber.

If enacted, these provisions will drain in excess of $4 billion from the industry's cash flow in the first 5 years after enactment, presumably in 1986 through 1990. The very close relationship between cash flow and capital spending in the past suggests that the $4 billion loss in cash flow would contract capital outlays by at least an equivalent amount. The reduction in capital spending would not only affect domestic supplies in international competition, but would also have a negative effect on supplier industries.

On the basis of the model constructed by the American Paper Institute, we can estimate the effect on the industry and its suppliers over the 5-year period, 1986 through 1990. We are talking about 180,000 fewer jobs, a $4 billion loss in payrolls, a $17 billion loss in sales, a $1.3 billion loss in corporate profits, a $1.2 billion loss in income taxes, and of course, additional losses in payroll and State and local taxes.

I mentioned earlier that our international competitiveness would be reduced by these actions. Our principal competitors are in Canada and Sweden. The U.S. capital recovery system ranks near the top among the principal industrial countries of the world in both the present value of total cost recovery and the cost recovery during the first 5 years.

As a practical matter, company capital spending decisions are generally placed on a planning horizon of 3 to 5 years. This means that cost recovery deductions in the first 3 to 5 years carry significant weight in capital planning decisions. We ought to maintain a policy that keeps us even with our international competitors. The proposed program would put us behind.

For timber growers, which include individual tree farmers as well as industrially owned lands, the proposed changes would discourage growth and result in a decline in our Nation's timber resources. Our ability to compete in international markets will be affected by the impact of these tax changes on the availability and cost of timber.

We believe Congress must recognize the fact that these specific proposals will limit growth in strong, competitive industries like the paper industry. We urge you to consider the following changes in the President's proposal.

First: eliminate recapture; second, provide for a capital recovery system that approximates the current combination of ACRS and ITC for expensing; third, in the event that a new capital recovery system is adopted, transition rules should apply for those who have made investments under ITC; fourth, preserve the current method of computing the foreign tax credit; fifth, retain the current deductibility of timber management, maintenance, and carrying costs as under present law; and last, we would like to see capital gains for timber retained. Thank you very much.

Senator SYMMS. Thank you very much for an excellent statement. Mr. Koontz.

[The prepared written statement of Mr. Laimbeer follows:]

STATEMENT OF WILLIAM LAIMBEER, REPRESENTING THE AMERICAN PAPER INSTITUTE

My name is William Laimbeer and I am President of the Diversified Division of Owens-Illinois, Inc. I am pleased to have this opportunity to comment on the President's tax proposals on behalf of the American Paper Institute.

The American Paper Institute has over 175 member companies which provide more than 90% of the pulp, paper and paperboard manufactured in this country. Paper and Allied Products rank among the largest industries in the United States with revenues close to $72 billion.

The wide use of paper and paper products makes this industry especially sensitive to policies that affect the over-all economy as well as capital intensive industries like ours.

The paper industry produces a myriad of products that are used by business and individuals--from packaging papers, boxes, printing and copying papers to various tissue products. It is part of Smokestack America because of its age and process, but from there on the similarity ends. The industry has grown in both domestic and international markets.

Certain important grades of paper have grown at rates faster than real GNP during the past fifteen years, others closely approached GNP growth. Printing and writing papers, an important part of our information technology society, experienced an increase of 3.4% year in demand in the 1969-1984 period. While real GNP increased 2.8%, linerboard, the raw material for shipping containers, advanced 2.5% a year.

This year the industry will spend over $8 billion for plant and equipment, five times the level of expenditures in 1969. During the

This year the industry will spend over $8 billion for plant and equipment, five times the level of expenditures in 1969. During the fifteen year period 1969-1984, capital outlays advanced 11% a year, while dollar sales increased 9% annually. For 1984 as a whole, the industry operated at a high average rate of 94% of capacity, but in the first half of that year operating rates were as high as 96%, which is the practical maximum operating rate for the industry as a whole . The demand for some grades of paper was so intense that some mills actually achieved operating rates of 100%. The industry generally operates at a fairly high rate of utilization of its capacity, except in recession years.

Up until 1984 the U.S. pulp and paper industry was considered the leader and the least-cost producer worldwide. It was the model for foreign competitors, with its well-managed forest lands and highly productive modern mills. Exports of linerboard (a major export grade for the industry) rose in a steady trend, from about 8% of its output in the early 1960's to 14% in the early 1980's. Similarly, exports of market pulp averaged 40% of market pulp production in the early 1960's and 54% in the early 1980's. The U.S. industry's cost advantage and its export growth were halted by the strong dollar, however, and in 1984 exports declined in both tonnage and as a percent of U.S. output.

Historically, the major imported grade of paper has been newsprint. We have depended on newsprint imports, primarily from Canada, to provide about two-thirds of our needs. An aggressive investment program in newsprint mills by U.S producers, particularly in the South, in the late 1970's and early 1980's reduced this dependence to less than 60%.

Large investments were a necessary part of the growth in production and exports.

The rapid advance in capital outlays in this industry was paced by the confidence of U.S. paper producers in the growing domestic and international market for many of the industry's products, by prudent long-range planning for raw material needs, particularly wood, and by careful but, nonetheless, aggressive financial management. Paper producers have concentrated their investments in the manufacture and distribution of paper and products. Very few investments were made outside the industry. The evaluation of market conditions was the primary influence in these decision.

The role of accelerated capital recovery, including the Investment Tax Credit, was to accelerate the spending decisions. The availability of tax incentives helped the industry maintain high investments even in periods of recession and reduced cash flow such as in 1981 and 1982. When one considers the highly volatile and postponable nature of a capital spending decision, the availability and flexibility of targeted investment tax incentives contributes to greater stability in economic activity.

The substantial investments did not apply to new mills or to new capacity alone. They were made in large part to modernize operations and cut costs in existing facilities. As a result of these capital outlays, the industry's costs to produce a ton of paper in real terms were no higher in 1982 than they were in 1977, according to official government figures. In addition, our record in meeting environmental requirements is one that we can be proud of: our industry was publicly lauded, for example, for its performance in meeting clean water standards. These environmental outlays are significant, and in the mid-1970's they amounted to 30% of our total capital expendirutes. After the oil price explosion in 1973, the industry allocated as much as 7% of its capital outlays for energy conservation, resulting in energy savings of 40% of fossil fuel and purchased energy used per ton of pulp, paper and paperboard between 1972 and 1984. Despite these high priority needs, the industry continued to spend significant amounts on the modernization and expansion of capacity.

We cite these brief historical examples to show that the industry has acted responsibly to meet mandated environmental and safety requiremtns, as well as the growing needs of customers at home and abroad. Investment is an important part of this responsibility. Tax benefits did help in the timing of the required investments.

It is for this reason that we are particularly concerned with those parts of the tax reform proposals that affect capital formation. Specifically, these include:

- Recapture of the tax benefits obtained from the use of accelerated recovery systems from 1980 through June 1986.

- Replacement of the current Investment Tax Credit and Accelerated Cost Recovery System with a less favorable Capital cost Recovery System.

- Removal of the Investment Tax Credit on January 1, 1986.

- Changes in foreign tax credits.

- Capitalization of timber management expenses.

- Elimination of capital gains treatment of timber.

We estimate that these six provisions, even after allowing for the corporate profits rate reduction, will drain $4 billion from the industry's cash flow in the 1986-1990 years. The very close relationship between cash flow and capital spending in the past suggests that capital spending would decline by at least $4 billion in that period. The failure to invest $4 billion will leave the U.S. industry and its customers more vulnerable to foreign competition and could limit our export opportunities. A model constructed by the American Paper Institute based upon government data shows the significant multiplier effect of this $4 billion shortfall in investment. This means for the industry and its suppliers over the five-year period:

180,000 fewer jobs
$4 billion loss in payrolls
$17 billion loss in sales
$1.3 billion loss in profits
$1.2 billion loss in tax revenues to the government.

Additional billions in revenues from payroll and state and local taxes would also be lost.

International competitiveness is another significant aspect of these proposed tax changes. As these tax incentives decline for American investors, foreign investors continue to have the same incentives as they had before. Coming at a time when the strong dollar is already creating turmoil in the U.S. industrial base, these tax changes will have a negative effect on the investments made by Americans in production facilities, including those of the paper industry. The Administration's proposal creates a more distorted playing field than currently exists. While the ACRS/ITC combination produces capital cost allowances roughly comparable to other major industrial competitors, CCRS alone would put U.S. manufacturers at a distinct disadvantage.

Under this proposal the U.S. would fall far behind most of its major competitors, including Canada and Sweden, in cost recovery allowances during the first five years. The United States currently ranks near the top among the principal industrial countries of the world in both the present value of total cost recovery deductions and the cumulative cost recovery through the first five years. Under proposed CCRS, the United States would rank among the lowest in the present value of cost recovery allowances during the first three or even five years.

This is particularly significant because it is the rapidity with which costs are recovered that determines to a great extent the level of reinvestment in new capital equipment. As a practical matter, company capital spending decisions are generally based on a planning horizon of 3-5 years. This means that cost recovery deductions in the first 3 to 5 years carry significant weight in capital planning decisions.

The paper industry has made and sees the opportunity to make productive investments that will enable it to continue to compete aggressively in world markets. Although the historic cost advantage of U.S. mills has been dissipated by the over-valued dollar since 1983, U.S paper producers can look beyond the valley to the time when they can reassert their cost advantage, assuming that they maintain adequate investments.

For these reasons we urge you to give careful consideration to the negative effects on capital formation and growth of the proposed changes in capital recovery.

The remaining sections of the testimony will deal with the effect of these proposed changes on the paper industry.

RECAPTURE OF ACCELERATED COST RECOVERY SYSTEM TAX BENEFITS

The President's proposals include a provision which unfairly recaptures over a three-year period the "excess" cost recovery benefits, as defined in the proposal, from January 1980 to June 1986 on assets placed in service between 1980 and 1985.

This proposal, in effect, imposes a retroactive penalty on these investments. Clearly, this provision impacts those very corporations which have spent most heavily on depreciable assets, relying on existing tax laws. In their reliance on these laws, these taxpayers expected a rapid recovery of their cost as provided by statute, but this provision will reach back 6-1/2 years to take away much of the cost recovery on investments already made.

The recapture provision is clearly discriminatory. There are many situations in which tax benefits have been taken at 46%. Why does this proposal leave undisturbed other provisions similar in nature to ACRS deductions, such as bank bad debt loss reserves, completed contract and percentage of completion methods, the installment sales method, cash basis accounting, and dividends accrued before repatriation? Clearly, there are many provisions that could be included in recapture, based on the same rationale given in the "reasons for change" and "analysis" sections of the President's proposal. Nonetheless, this proposal singles out for a penalty only the depreciation so important to capital intensive industries and the country's productivity.

This proposal is a major component of a multiple attack on those capital intensive companies that would be adversely affected by the prospective changes in cost recovery including the elimination of the investment tax credit and the costly recapture provision. The combined effect of these sudden reversals in cost recovery would be a sharp short-term increase in tax revenues for the Federal Government but a severe and prolonged downward impact on cash flow and future capital spending. Long term tax revenues would also be affected in a negative way.

There is no precedent for this recapture provision. In all prior rate reductions, from 52% to 50%, to 48%, and to 46% the Treasury has never taken action to reduce depreciation taken prior to rate reduction.

Our major concern is the significant drain on business cash flow and capital investment that will result from this arbitrary recapture rule. The 3 years of cost recovery recapture will reduce cash flow in our industry alone by more than $1.2 billion. One result will be the interruption in midstream of some of the capital spending programs initiated when more rapid cost recovery was available.

This unprecedented recapture provision is another link in the chain of uncertainty and instability fostered by the frequent and major changes in tax law in the 1981-1984 years. Now not only is business faced with prospective tax law changes; it has to calculate changes of prior laws. Tax planning, tax administrative processes, and tax calculations are made much more difficult. No one can consider this provision as simple, fair, or pro-growth.

CAPITAL RECOVERY SYSTEM

Removal of the Investment Tax Credit and the substitution of the Capital Cost Recovery System for ACRS will significantly reduce the cash flow of this industry and raise its capital costs. We estimate the reduction in cash flow over the 1986-1990 period will be $4 billion from these and other provisions with a corresponding contraction in spending for plant and equipment. The consequences will be less aggressive foreign marketing, more imports, less employment growth and lower over-all tax payments.

The faster capital cost recovery which became available after 1981, coupled with the investment tax credits, have been significant factors in escalating investment in plant and equipment in the United States during recent years. Both accelerated cost recovery and the ITC are efficient, targeted investment incentives available only when expenditures on qualified capital assets are made. Over the years a positive relationship between capital investment and the enactment of the investment tax credit appears to exist. From the initial use of the ITC in 1962 to subsequent suspension, reenactment, repeal, restoration, and even rate changes, the relationship between the tax change and subsequent capital spending decisions is clear.

The General Explanation of ERTA (Public Law 97-34) prepared by the Staff of the Joint Committee on Taxation made the following statement concerning capital formation only four short years ago: "Business investment in new plant and equipment is crucial for increasing worker productivity, which holds down the rate of inflation and improves the nation's competitiveness in international trade. Yet, investment spending in excess of that needed to replace worn-out plant and equipment has been too small...and an increasing share of that spending has been for satisfaction of government mandated requirements, and thus has not necessarily augmented capacity to produce." Investment incentives were provided to capital formation by that tax bill and, not surprisingly, business spending decisions responded positively, and a stronger economic recovery resulted. Since that time, these incentives have been whittled down by two subsequent tax bills. One must wonder why incentives which were so vital only four years ago and whose success have been clearly demonstrated should be so dramatically weakened now.

The combination of the existing ACRS and ITC system has been proven successful. Whatever the form, we mush approximate that pace of capital recovery. Loss of the investment tax credit, without significant improvement in the proposed cost recovery system, would retard future investment and growth.

The combination of the investment tax credit and the accelerated recovery system is approximately equal to expensing on a present value basis when one assumes a 5% inflation rate and a 4% real rate of return. We must maintain a system that approximates expensing in order to grow. Whatever combination of incentives the Congress chooses to achieve that end, the goal must be equivalent to expensing, with a certainty of rapid early cost recovery

There are various concepts and proposals which would meet this objective, and some of the proposals which have been introduced in this Congressional session would provide the basic ingredients. We will be pleased to discuss these and/or other proposals with Members of Congress.

IS CCRS NEUTRAL?

We believe the proposed recovery system is not only not neutral but even more significantly, it is distorting. Most of the paper industry's equipment would fall in new CCRS Class 4. Assuming the same 5% inflation and a 4% real rate of return, the present value of deductions under the proposed system would be .890, considerably less than the 1.01 with the existing ACRS/ITC system.

The existing system provides a level playing field between expensed costs and investment in capital equipment. This was one of the reasons ACRS was proposed by this Administration just 4 years ago. The proposed CCRS, by making the present value less than 1.0, would create a tax-motivated distortion in favor of expensible costs and against capital investment. This violates the stated objective of tax reform to achieve neutrality.

Investment in new plant and equipment along with research and development are part of the process of technological change. R & D must be translated into practical, useful processes and products, which require heavy investment in new productive facilities. While intangible R & D would continue to be expensed under this proposal, this industry's tangible investments in technology would be subject to even less favorable tax treatment than under current provisions.

IS CCRS SIMPLE?

The Administration's proposal increases the number of classes and requires the taxpayer to reclassify property to a greater extent than under ACRS. A major complexity is introduced by the need to make inflation adjustments and to keep records over a longer time period. To comply with the tax proposals and the dividend deduction proposal requires two additional sets of records, which clearly departs from the objective of simplification.

INVESTMENT TAX CREDIT

Repeal of the investment tax credit will lead to lower investment in new plant and equipment, with consequent lower productivity and a dampening of economic growth and employment.

If the investment tax credit is eliminated, with or without a suitable replacement, it is essential that appropriate transition rules be enacted. Failure to grandfather projects already committed, which were approved on the basis that ITC would be available, would deal a particularly heavy blow to those businesses which had already incurred risk and liability for these projects.

It is not unusual for a capital project to require a time frame of much more than a year from the date of commitment until it is placed in service.

Past tax treatment has generally recognized this fact. The decision to go forward with a project is based on a combination of economic projections and evaluations made prior to the commitment. Two important components of these projections are an estimate of return on investment and cash flow.

The investment tax credit is a significant factor in the cash flow projection. This is how the evaluation is made: If a manufacturer acquires a machine for $10,000,000 in 1985, it will have to find $8,344,500 to pay for it under present law which permits a 10% investment tax credit. Without the investment tax credit the amount requiring financing would be $9,310,000 or about $1 million more.

	With ITC	**Without ITC**
Cost	$10,000,000	$10,000,000
Less 10% ITC	(1,000,000)	
Less 1st year ACRS @ 46%	(655,500)	(690,000)
Required funding	$8,344,500	$9,310,000

But the proposals would add an even larger burden than $1 million. Assuming that the same machine is ordered in 1985 but not placed into service until 1988, and the President's proposal is enacted, the effect would be a significant increase in cash funding requirements which are now calculated at $9,637,000.

Without ITC

Cost	$10,000,000
Less 1st year CCRS @ 33%	(363,000)
Required funding	$9,637,000

The tax reform proposal would create a funding shortfall to the taxpayer in the amount of $1,292,500, or 13% of the project's cost. Of this amount, $965,500 is attributable to the repeal of the ITC (with its corresponding basis adjustment) and $327,000 is attributable to the change from ACRS to CCRS. When the order for the machine was placed in 1985, the manufacturer planned on his cash needs to be $8.3 million, not $9.6 million.

The financial obligations incurred by the company on the assumption that these credits would be available certainly places a moral obligation upon government to provide, as in the past, a transition rule (e.g., Reg. Sec. 1.46-1(g)). Failure to provide transition rules for projects committed but not installed as of January 1, 1986, will force business to curtail future investment.

FOREIGN TAX CREDITS

Replacing the overall method of computing the foreign tax credit limitation with the complex per-country method will impose additional tax burdens on U.S firms' foreign operations. This amounts to, in many cases, double taxation of the same amount, which is precisely what the foreign tax credit rules are designed to prevent.

This additional tax burden would be imposed at a time when United States business is facing unprecedented and, at times, unfair competition from abroad. The proposed change to the per-country method should be considered in the context of previous administrative and legislative actions, such as the Section 851 regulations (allocation and apportionment of deductions against foreign source income) and the resourcing and recharacterization rules of the Tax Reform Act of 1984, which have already severely circumscribed the use of the foreign tax credit. The per-country limitation will further erode the availability of the foreign tax credit as a safety net against double taxation on foreign operations.

In the paper industry, foreign operations are net providers of jobs and payments to the U.S. Many U.S owned foreign plants are integrated into their U.S parents' domestic operations and provide outlets for U.S. production that would not otherwise be produced. One example is U.S linerboard sold to an affiliate foreign box plant where it is converted into shipping containers.

Therefore, the additional tax burden this proposal would impose would discourage U.S. corporations from operating abroad with the resultant negative effects on the U.S. economy.

PROPOSED CHANGES IN THE TAXATION OF TIMBER

Fifty-nine percent of the commercial forestland in this country is owned by individual tree farmers, while only 13% is owned by the industry. Most of our member companies rely on other owners, including individuals, for well over half the timber suppled to their mills. For timber growers the Administration's tax proposal is neither fair nor simple; rather than encouraging growth, it would result in a decline in our nation's timber resource. For the paper industry the future availability and cost of timber resources have a direct effect on our ability to compete in the international marketplace.

One proposal could change current law, which permits a taxpayer to deduct annually the costs of (1) fire and insect control, maintenance, and management of timber after the seedlings are established, (2) property taxes, and (3) interest, to require the capitalization of all such costs. Further, it would repeal capital gain treatment for timber, which for more than the last 40 years has been available to timber growers regardless fo how they may dispose of their timber. Finally, it would repeal a current law provision that permits small timber owners to amortize over 84 months up to $10,000 of reforestation expenses annually and to claim a 10% investment tax credit thereon.

These proposed changes disregard the historic response that the timber supply has shown to federal tax policy. Prior to 1944, the year in which the capital gain provisions that the Administration is now proposing to repeal were enacted, the annual supply of timber was decreasing.

Since that time, however, the nation's inventory of standing timber has increased by more than 195 billion cubic feet, with new planting now in the hundreds of millions each year.

Additionally, adoption of the tax proposals would further jeopardize the role that forest products play in international trade and our balance of payments. Historically, timber has been one of our nation's leading exports. By making investments in timber less attractive, the proposals would erode our competitive position in world markets.

In summary -

- The proposals would encourage liquidation of existing timber holdings and discourage new investments in timber growing and forest management. The effect of these will be a substantial decrease in the availability of future timber resources.

- The proposal is unfair to the hundreds of thousands of timber owners who planted timber relying on capital gain treatment upon its harvest.

- These proposals unfairly single out investments in timber from investments in all other assets by requiring the capitalization of timber management expenses and carrying charges.

- The proposals do not promote simplicity. Especially for the smaller timber owner, the required records and computations would increase exponentially.

Therefore, we recommend retaining the existing timber capital gains treatment, the present deduction of timber protection, maintenance, and management expenses and carrying costs, and the present incentives for reforestation.

These issues will be addressed in much greater detail in the testimony to be delivered by the Forest Industries Committee on Timber Valuation and Taxation ("FICTVT"). API fully supports the statement and the efforts of the FICTVT in retaining the present tax treatment of timber.

CONCLUSION

We believe Congress must recognize the fact that these specific proposals will limit growth in strong competitive industries like the paper industry. We urge you to consider these changes to the President's proposal:

1. Eliminate recapture.

2. Provide for a capital recovery system that approximates the current combination of ACRS/ITC or expensing. In the event that a new capital recovery system is adopted, provisions should be made for those who have made investments under ITC in the transition.

3. Preserve the current method of computing the foreign tax credit.

4. Retain the current deductibility of timber management, maintenance and carrying costs as under present law.

5. Retain capital gains for timber.

STATEMENT OF JAMES L. KOONTZ, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KINGSBURY MACHINE TOOL CORP., KEENE, NH; AND CHAIRMAN OF THE BOARD, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION, ACCOMPANIED BY JAMES H. MACK, PUBLIC AFFAIRS DIRECTOR, NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION

Mr. KOONTZ. Thank you, Senator. My name is James L. Koontz. I am president of the Kingsbury Machine Tool Corp. located in Keene, NH. I also serve as chairman of the National Machine Tool Builders' Association, on whose behalf I am appearing today. With me this morning is James H. Mack, NMTBA public affairs director.

From the perspective of the U.S. machine tool industry, the proposed repeal of the 10-percent investment tax credit and the depletion of accelerated depreciation through the so-called recapture provisions represent a disturbing and unwarranted retreat in the battle to keep America's basic manufacturing industry vibrant and competitive. Clearly, continued investment in new productive plant and equipment is essential if the American machine tool industry and its customer base are to mount a credible challenge against foreign competition, both at home and abroad.

It must be recognized that the ITC and the ACRS are in effect competitive tools which permit manufacturers to make capital investments sooner, rather than later—that is to make those investments which, at the margin, would otherwise be deferred or not made at all. The availability of this enhancement is crucial during a period in which, competitively speaking, timing is everything. Repeal of the ITC and depletion of the ACRS, corporate rate reductions notwithstanding, would strike a disastrous blow to capital formation.

This undesirable result would be at least partially avoided by placing machine tools in the depreciation class in which they properly belong, a class which includes computers and other equipment that typically experience sweeping technological change. A depreciation schedule which amortizes machine tools over too lengthy a time period will not provide the cash flow necessary to replace technologically obsolete equipment in a timely fashion.

Treasury's proposed elimination of the ITC and the depreciation recapture proposal represent a change of direction which is abrupt and, we believe, ill-considered. Just 4 short years ago, Congress gave basic manufacturing industries a very clear signal: invest in new plant and equipment, revitalize, clean up your act; and the machine tool builders did do just that. Now, they find themselves facing a new tax which, in effect, punishes them for taking steps to improve productivity. It should also be recognized that the administration's capital cost recovery provisions actually place most equipment in a position less generous than the pre-1981 law, which virtually, everyone agreed was inadequate to keep U.S. industries competitive. We will provide the committee with a chart to substantiate this assertion. Our written submission shows that historically investment spending has been highly responsive to changes in the ITC.

We firmly believe that if the ITC is eliminated, Congress will reinstate it within 2 years. But by then, it will be too late. Erosion of U.S. manufacturing capability will be too far along.

It is well settled that a viable machine tool industry is critical to the national security of the United States. The industry received overwhelming bipartisan support from Congress for a favorable ruling on its national security petition. Yet despite this gratifying response to the industry's plight, the petition remains hung up in the National Security Council, and the President still hasn't acted after 19 months. Instead of giving us an answer, the administration has given us a tax proposal which will make us less competitive. Worse yet, this action comes at a time when the Soviet Union is pouring billions into the building of a strong machine tool industry.

We would like to commend the committee's attention to legislation recently introduced by Senators Grassley, Heinz, and others, which imposes a 90-day time limit on future 232 cases and mandates an immediate favorable decision on the machine tool case unless the President successfully negotiates a voluntary restraint agreement with Japan.

International competitiveness and innovation go hand in hand. NMTBA therefore fully supports retention of the R&D tax credit. A three year extension, the administration has proposed, does not provide the certainty required for prudent R&D planning. A permanent tax credit would be more desirable.

Any discussion concerning the retention of provisions such as ACRS and ITC associated with significant revenue impact inevitably gives rise to the question of how it will be paid for. In this regard, we urge this committee to consider the concept of a business transfer tax. We believe that this concept, a form of which was introduced by Senator Roth earlier in the year, can help maintain revenue neutrality while encouraging capital formation and economic growth, provided that the revenue generated by this proposal is not used to pay for lower rate cuts and/or the retention of such items as the State and local tax deduction. Thank you.

Senator SYMMS. Thank you very much, Mr. Koontz.

[The prepared written statement and charts of Mr. Koontz follow:]

STATEMENT BY
JAMES L. KOONTZ
PRESIDENT & CHIEF EXECUTIVE OFFICER
KINGSBURY MACHINE TOOL CORPORATION
REPRESENTING THE
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 2, 1985

I. INTRODUCTION - INDUSTRY OVERVIEW

Good morning, my name is James L. Koontz. I am President and Chief Executive Officer of the Kingsbury Machine Tool Corporation. The company is located in Keene, New Hampshire and employs 850 persons. We manufacture drilling and tapping machines, manufacturing systems and auxiliary equipment. I am appearing today on behalf of the National Machine Tool Builders' Association (NMTBA), a national trade association representing companies which account for more than 85 percent of domestic machine tool production. With me this morning is James H. Mack, NMTBA Public Affairs Director. As you know, Mr. Chairman, the industry represents a small but strategic segment of the nation's industrial capacity.

NMTBA appreciates this opportunity to discuss the Administration's tax "reform" proposal. Certainly we applaud the bipartisan interest in reducing marginal tax rates and making our tax code less cumbersome and more efficient. But when the Administration crafted a proposal allegedly governed by principles of growth, simplicity and fairness, we believe that machine tools were left out of the equation.

From the perspective of the U.S. machine tool industry, the proposed repeal of the 10 percent investment tax credit (ITC) and the depletion of accelerated depreciation schedules (ACRS) through the so-called "recapture" of depreciation "windfall" represent a disturbing and unwarranted retreat in the battle to keep America's basic manufacturing industries vibrant and competitive. The unmistakable message which underlies these proposals -- that struggling capital-intensive industries which are trying to remain competitive should throw in the towel, because they "are not worth saving" -- carries ominous implications for the future of America's basic manufacturing industries and, consequently, for the future of America's entire defense/industrial foundation and international competitive standing.

In order that our specific concerns may be more readily appreciated, we would like to begin with a very brief overview of the domestic machine tool industry and where it is today.

Throughout 1983, while the economy as a whole experienced relatively robust growth, the machine tool industry failed to share in the cyclical expansion. In fact, when measured in terms of shipments, 1983 was a disastrous year. However, the machine tool market appeared to be gaining momentum during 1984. New orders for 1984 were 72 percent ahead of comparable 1983 figures -- though one must bear in mind that 1983 orders were at one of the lowest points in the industry's history. Shipments, reflecting the relatively slow pace of 1983 orders, were up 23 percent over 1983 levels.

The Committee should be aware that the above-mentioned indicators, while positive, by no means signal a full-fledged return to prosperity for the entire industry. To the contrary, most machine tool builders continue to remain in a state of severe financial strain due to the modest recovery in shipments. And, as our comments below will illustrate, the proposed elimination of the investment incentives provided by ACRS and the ITC will have a devastating impact on capital investments -- both by our customer base and by the machine tool industry itself.

Another major factor complicating the prospect for recovery is the specter of further import inroads into the American machine tool market. Consider that imports, measured by value, presently account for more than 40 percent of domestic machine tool consumption -- and imports have shown every sign of maintaining or increasing this market share. Therefore, although we are, on the whole, headed in a more prosperous direction, 1985 promises to be another difficult year for the machine tool industry.

II. CAPITAL FORMATION IS ESSENTIAL TO INTERNATIONAL COMPETITIVENESS

The competitive challenges confronting the U.S. machine tool industry are representative of what many basic domestic industries have experienced in recent years -- burgeoning import penetration and the predatory trade practices of foreign competitors; a sluggish world economy which has, only recently, shown signs of significant recovery; unnecessarily burdensome export control policies; and perhaps most importantly, the overvalued dollar. In addition, the integration of computer technology with metalworking equipment has revolutionized basic manufacturing processes.

These developments have combined to exert unprecedented competitive pressure on American machine tool builders struggling to maintain a viable posture in what is, increasingly, a global market. The adverse competitive impact is, perhaps, most readily apparent when viewed in terms of the industry's shocking deterioration in export performance. Exports by machine tool makers exceeded $1 billion in 1981; by 1984, the industry's exports had fallen to approximately $400 million -- a decline of 60 percent in just three years.

Clearly continued investment in new productive plant and equipment is essential if the American machine tool industry and its customer base are to mount a credible challenge against foreign competition -- both at home and abroad. We are not suggesting that investment incentives alone represent a panacea to the industry's competitive problems. We are saying, however, that the importance of such incentives should be viewed in the context of what can accurately be described as a hostile international trading environment.

It must be recognized that the ITC and ACRS are, in effect, competitive tools which permit manufacturers to make capital investments sooner rather than later -- that is, to make those investments which, at the margin, would otherwise be deferred or not made at all. The availability of this enhancement is crucial during a period in which -- competitively speaking -- timing is everything.

I am speaking from experience -- last year, for example, my own company invested almost $3 million dollars in new equipment in order to keep ahead of foreign competitors. Fueling that engine for substantial capital investment was the ITC.

The President's Commission on Industrial Competitiveness has recognized the importance of productive capital. The Commission recently recommended that "we must more aggressively update our capital stock and provide all members of our work force with the plants and equipment they need to match the productivity improvements of their competitors abroad."[1] In this regard the Commission observed:

> Capital is the fuel for our economic machine. Invested in productive assets like buildings and machines, capital provides the tools we need to compete. Invested in research and development, it provides the technological advances that are the key to competitiveness.... The productive and creative use of capital is a strong factor in any nation's competitive position.[2]

Yet repeal of the ITC and depletion of ACRS -- corporate rate reductions notwithstanding -- would strike a disastrous blow to capital formation. Under current law, for example, manufacturers can recoup approximately 25 percent of their investment in machine tools during the first two years of usage. Under the Treasury Department's proposed CCRS, only 10 percent of that investment would be recoverable during the first two years.

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[1] "Global Competition: The New Reality," The Report of the President's Commission on Industrial Competitiveness, at 25. (1985, Vol. I).

[2] _Id_.

III. TREASURY HAS MISCLASSIFIED MACHINE TOOLS FOR DEPRECIATION PURPOSES

This undesirable result would be at least partially avoidable by placing machine tools in the depreciation class in which they properly belong -- the class which includes computers and other equipment which typically experience sweeping technological change.

The overwhelming majority of today's most productive machine tools are computer controlled. As a result, the design, manufacture and application of both individual machines and systems are tied directly to the state-of-the-art of the computer control itself. This integration of technologies extends not only to the machines and controls, but to auxiliary functions such as those performed by robotics and sensing devices.

Because electronic technology evolves far more rapidly than mechanical innovation and invention, machine tool technological obsolescence has been considerably hastened. Preliminary estimates indicate that the technology involved in more than 75 percent of the machine tools being sold today did not exist five years ago.

Today's machine tools are thus designed to follow the technological life of the control. This development is evidenced by the fact that the International Machine Tool Show -- the leading machine tool marketing exhibit in the world -- while once held on a five-year cycle, is now held every two years. Machine tool technology is moving that fast. As a result, product life cycles are becoming increasingly shorter.

Equipment produced more recently loses its economic value much more rapidly, because technology is advancing at an extraordinary pace, making yesterday's technology obsolete. Here are two examples. A Brown & Sharpe machining center sold in June, 1981 for $146,100 was resold at auction in October, 1984 for $65,100. A Warner & Swasey CNC lathe sold in June 1980 for $260,000 was resold at auction in October, 1984 for $84,500. (Incidentally, the CNC control technology available for CNC machine tools has gone through 3 generations since 1980!) The accumulated depreciation for these two recent vintage machines was $256,600 or (using straight line methods) $73,314 per year. The newer vintage equipment would have been completely amortized in an average of 5.5 years.

The trendline is clear -- resale prices in auctions held in 1984 show that the actual depreciable life of newer machine tools is 44% below the actual depreciable life of older models.

It should also be remembered that historically, under the pre-1981 system, machine tools were assigned an ADR mid-point significantly shorter than other types of equipment now included in Depreciation Class Four, into which Treasury has misguidedly placed machine tools. The twelve-year ADR midpoint originally assigned to machine tools in 1971 was reduced to 10 years by Treasury regulation in 1975. (Thus, the cost, minus salvage value, could be amortized over an eight year period using accelerated depreciation methods not permitted under ACRS.) Today -- ten years later -- advances in both computer controls and machine tools have caused technological obsolescence to occur in an even shorter time frame.

The distinction between what works and what works best makes all the competitive difference. Access to the very latest manufacturing technology is, therefore, a competitive necessity for the U.S. machine tool industry and its customers.

A depreciation schedule which amortizes machine tools over too lengthy a time period will not provide the cash flow necessary to replace technologically obsolete equipment in a timely fashion. Machine tools should be placed in an asset classification that permits depreciation over no more than five years, because that is the time frame within which true economic depreciation occurs.

IV. CAPITAL FORMATION AND DEFENSE PREPAREDNESS ARE INEXORABLY LINKED

It is well-settled that a viable machine tool industry is critical to the national security of the United States -- this is the industry that builds the machines which are the cornerstone of virtually all military production. A tax policy biased against capital intensive industries would, therefore, significantly undermine U.S. defense preparedness. As our comments will illustrate, the further erosion of our defense/industrial base is a development we can ill afford.

Two years ago NMTBA appeared before this Committee to discuss the national security threat posed by spiraling machine tool imports, the bulk of which were -- and continue to be -- highly sophisticated and defense-sensitive.[3]

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[3] See, Congress, U.S. Senate, Committee on Finance, Subcommittee on Economic Growth, Employment and Revenue Sharing, James A. Currie, Jr., President, Erie Press Systems (representing NMTBA), October 3, 1983 (98th Cong., 1st Session.).

As you know, Mr. Chairman, early in 1983 NMTBA in response filed a Petition for temporary import relief with the Secretary of Commerce under Section 232 of the Trade Act of 1962, the National Security Clause. While the Association has long been a proponent of free trade and has one of the most active international trade promotion efforts in the trade association field, we could not stand idly by while key segments of the American machine tool industry are decimated by targeted sales of foreign machine tools -- and, more importantly, while the national security of the United States is imperiled by the transfer of machine tool productive capacity to the Far East.

The Commerce Department submitted a reportedly favorable recommendation for action on the Petition to the President on February 28, 1984. Thus, for the past 19 months, the fate of the industry's future has rested squarely in the Oval Office. We received overwhelming bipartisan support from Congress for a favorable ruling and we appreciate the leadership and support of many members of this Committee in that effort. Yet, despite this gratifying response to the industry's plight, the Petition remains hung up in the National Security Council and the President still has not acted.

When this country cannot get what it needs in an emergency, the authorities invariably ask, "Why didn't someone tell me about this so that corrective action could be taken?" For more than two years our industry has been doing just that -- telling responsible government officials of the potential danger. But the NSC apparently has decided that the President doesn't need to know about this problem.

In that regard we would like to commend the Committee's attention to legislation (S.1679), recently introduced by Senators Grassley, Heinz, and Proxmire, which imposes a 90 day time limit on Presidential decision-making in future 232 cases and mandates an immediate favorable decision on the industry's 232 Petition, unless the President successfully negotiates a voluntary import limitation with Japan.

With more than two years having passed since the initial filing, most NMTBA members, aware that a timely resolution is not forthcoming, have, out of necessity, moved ahead with investment decisions that could no longer be postponed. Some manufacturers completely withdrew from the machine tool business; some entered into marketing agreements with their foreign counterparts and are now distributing foreign-made machines; others are transferring what is left of their operations offshore.

The point is that those firms choosing to continue in the business of machine tool manufacturing in this country need, more than ever, capital investment incentives in order to improve productivity and remain competitive. And the industry's customer base, which is also shrinking, needs these incentives as well. Reduction of cash flow caused by the elimination of these incentives, coupled with reduced profit margins, will intensify their need to buy the cheapest products available -- regardless of quality or long-term productive capacity. Thus the price advantage of imports -- often a function of government-subsidized financing and always a function of the strong dollar -- will help assure further import inroads into the American machine tool market.

The importance of a strong industrial base and a vital machine tool industry has certainly been recognized by the Soviet Union. Soviet leader Mikhail Gorbachev recently revealed his determination to "restructure" the Soviet economy, "especially the machine tool industry; modernize existing capacity, introduce economic incentives to increase labor productivity and set a steady rhythm for the economy."[4] And a recent Defense Department publication states that the Soviet "machinery section continues to realize the most rapid growth in the economy."[5]

In other words, at a time when the Soviet Union is pouring billions into the building of a strong machine tool industry -- because of its recognition of the industry's importance to national security -- our own government is suggesting ways to hasten the decline of American machine tool manufacturing. Instead of giving us an answer to our national security trade Petition, the Administration has given us a tax proposal which will make us less competitive. It just does not make sense.

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[4] "Gorbachev's Vigor Raises Expectations," The Washington Post, June 4, 1985, at A1, A23 (emphasis added).

[5] "Soviet Military Power -- 1984" (U.S. Dept. of Defense, 1984).

V. CONTINUITY IS A PREREQUISITE TO SOUND BUSINESS PLANNING

It is indisputable that a tax policy characterized by "on again, off again" elements wreaks havoc with the decision-making process. In this regard, there are indications that the debate concerning the Administration's tax proposal is already imposing a substantial drag on the U.S. economy -- especially on capital equipment orders. "Some economic analysts fear that uncertainty over possible tax changes could cause a decline in business investment this year at a time when the sagging U.S.economy can least afford it."[6]

Treasury's proposed elimination of the ITC and its depreciation recapture proposal represent a change of direction which is abrupt and, we believe, ill considered. Just four short years ago, Congress gave basic manufacturing industries a very clear signal: invest in new plant and equipment, revitalize, "clean up your act." Machine tool builders who did just that now find themselves -- vis-a-vis the proposed recapture of depreciation -- in the untenable position of facing potentially heavy penalities for their good faith response to a signal which was distinct and unmistakable.

The machine tool industry includes many small companies struggling to remain viable by investing in capital improvements.

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[6] "Cost of Uncertainty: Reagan Tax Proposal Already Brings a Halt to Some Investment", The Wall Street Journal, June 19, 1985, at 1.

Just as these companies are beginning to regain their economic equilibrium, they are slapped with a new tax which, in effect, punishes them for taking steps to improve productivity. Clearly something is very wrong with a policy under which non-investing companies fare substantially better than those which -- at the express urging of Congress and the Administration -- undertook financial risks in order to invest in both their own futures and the future of America's defense industrial base.

We believe that the Treasury's recapture proposal -- the hurried product of a last-minute effort to make its package "revenue neutral" -- has simply not been thought out. It is bad public policy and fundamentally unfair. It seeks to recoup a $57 billion revenue shortfall from a single sector of the economy -- a vulnerable sector which can least afford the additional liability and which has already been asked to bear a disproportionate share of the burden vis-a-vis alteration of accelerated depreciation schedules and elimination of the ITC.

The Treasury consistently maintains that any additional tax liability imposed by its plan will be more than offset by "substantial" corporate rate reductions. We would remind this Committee that there is little benefit to be derived by small machine tool companies from a rate reduction if their customer base has been further eroded or if the companies themselves can no longer remain competitive. And their employees have little to gain from lower marginal rates and a simpler tax form if their jobs no longer exist.

VI. INVESTMENT SPENDING IS HIGHLY RESPONSIVE TO CHANGES IN THE ITC

Perhaps one of the most puzzling aspects of the Treasury proposal is that it seeks to eliminate provisions which are demonstrably successful -- the ITC and ACRS are, in fact, fulfilling the purpose for which they were enacted. As even Treasury admits, investment spending is highly responsive to changes in the ITC. It should also be recognized that, while some have attempted to justify the proposed revisions as a "necessary" adjustment in the wake of ERTA's "overly generous" business-related provisions (1982 revisions notwithstanding), the Administration's proposal actually places most equipment in a capital cost recovery position less generous than pre-1981 law!

Exhibit I shows that enactment of the ITC in 1962 dramatically reversed the decline in capital equipment share of real GNP that began in the mid-1950's. Suspension of the ITC in 1966-67 and again in 1969-71 interrupted the rise in equipment share. The reinstitution of the ITC in 1971, followed by the 1975 increase from 7 percent to 10 percent, have raised the capital equipment share of GNP to the highest levels of the past half-century. This investment surge has occurred despite the record-high real interest rates prevalent in recent years.

Historically the ITC has been viewed as an effective counter-cyclical device. Those proposing its elimination apparently believe that the highly touted economic "recovery" has, in effect, made the ITC obsolete. But the facts dictate otherwise. All recent trends indicate that business' planned expenditures for new plant and equipment have been revised downward and that most of the new spending has already occurred. Economists attribute the downward revisions to competitive problems encountered by the manufacturing sector of the economy -- problems brought on by "fierce competition from foreign suppliers."[7] Historical precedent strongly suggests that an unstable investment climate is the wrong time to eliminate effective investment incentives such as the ITC. It was, in fact, precisely this type of climate which gave rise to the initial enactment of the ITC. It hardly seems prudent to revoke it now.

If you carefully study the changes in direction of the investment and unemployment data shown in Exhibit 2, you can see that whenever investment stops growing or goes down, unemployment goes up. Conversely, for more than 30 years, whenever this nation has increased its business sector investment, the unemployment rate has declined.

Exhibit 2 makes it abundantly clear that America's unemployment problem will not be corrected by pouring federal tax dollars into make-work programs that have a long history of failure. Exhibit 2 shows that the way to correct the unemployment problem is to ensure absolutely that American business keeps its investment growing healthily.

We firmly believe that -- based upon historical Congressional recognition of the contribution made to investment growth by the ITC and the reduction in capital spending when it has not been in effect -- if the ITC is eliminated, Congress will reinstate it within two years. But by then it will be too late -- the erosion of U.S. manufacturing capability will be too far along. The mistakes of the past need not be repeated. The price of repetition could be the permanent loss of U.S. manufacturing competitiveness.

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[7] "Business Spending Plans Drop -- Outlay Plans Signal Weak Economy", The Washington Post, September 12, 1985 at B1.

VII. THE IMPORTANCE OF RESEARCH AND DEVELOPMENT

International competitiveness and innovation are inevitably intertwined. Taking into account the rapid advances in technology that are affecting the machine tool industry and its customers, it is not an exaggeration to say that expenditures for research and development are the lifeblood of the machine tool business. In order to compete effectively in the domestic and export markets, the industry must retain the ability and the incentive to continue and increase its R & D activity.

NMTBA is, therefore, gratified that the Treasury proposal reflects a recognition that incentives for technological innovation are both appropriate and necessary. Specifically, Treasury recommends a three-year extension of a narrowed version of the 25 percent R & D tax credit enacted in 1981 and currently scheduled to expire at the end of 1985.

NMTBA fully supports retention of the R & D tax credit. This incentive represents an especially significant resource for smaller firms which often have limited funds to invest in new technology. We believe, however, that a three-year extension does not provide the certainty required for prudent R & D planning. Because most R & D projects are long-term in nature, R & D budgets are necessarily determined years in advance. As a Joint Economic Committee Study recently recognized, a permanent credit would provide the needed certainty.[8] And the sooner that certainty can be established, the sooner machine tool builders and others will be able to factor the availability of the credit into their research agendas.

VIII. THE CONCEPT OF A BUSINESS TRANSFER TAX

Any discussion concerning the retention of provisions (such as ACRS and the ITC) associated with significant revenue impact inevitably gives rise to the question of how they will be "paid for." In this regard, we urge this Committee to consider the concept of a Business Transfer Tax (BTT).

All U.S. businesses would be subject to the tax. A firm's tax liability would be calculated by adding up all gross receipts and subtracting all purchases of raw material and other input. The tax rate would be a selected flat percentage. Each firm could apply its BTT revenues against liability for the employer portion of Social Security payroll taxes (FICA). The BTT with a FICA offset appears to be compatible with the idea of an "indirect" tax under the GATT. Export sales are, therefore, excluded from the tax base but the tax would be assessed on the full price of imports as they enter the United States.

We believe that this concept -- a form of which was introduced by Senator Roth earlier this year -- can help maintain revenue neutrality while encouraging capital formation and economic growth, provided that the revenue generated by this proposal is not used to pay for lower rate cuts or the retention of such items as the state and local tax deduction. Because our major trading partners collect much greater revenues from indirect taxes than we do, we agree with Senator Roth's assessment that the proposal is a first step toward bringing our tax system into line with that of our trading partners.

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[8] See, "The R & D Tax Credit: An Evaluation of Evidence on its Effectiveness," Joint Economic Committee Staff Study, August 23, 1985 (99th Cong., 1st Session).

IX. TAXATION OF EMPLOYEE BENEFITS

NMTBA would like to take this opportunity to commend you, Mr. Chairman, for your diligent efforts in negotiating a successful compromise with the Administration concerning the appropriate tax treatment of employee benefits. We urge this Committee not to disrupt that compromise by eliminating 401(k) plans.

NMTBA presently offers its employees a 401(k) Savings and Retirement Plan. The Plan, which has fostered a substantial increase in the individual savings of many NMTBA employees, provides an effective and attractive retirement/savings vehicle. Should the Plan be withdrawn, NMTBA could not provide its employees with tax-sheltered annuities offered under Section 403(b) of the code because such plans are limited to a narrow range of tax-exempt organizations -- a range which does not include trade associations.

It should also be recognized that Section 457 plans are not a viable alternative to 401(k) plans because they are unfunded and non-qualified. Contributions to a Section 457 plan would remain general assets of the Association and thus be subject to the claims of NMTBA's creditors. Consequently, a Section 457 plan would not provide NMTBA employees with the security of a 401(k) arrangement. In addition, Section 457 plans generally are not structured in a way which encourages or legally permits coverage for all levels of employees.

For these reasons, we urge the Committee to strongly oppose the elimination of 401(k) plans.

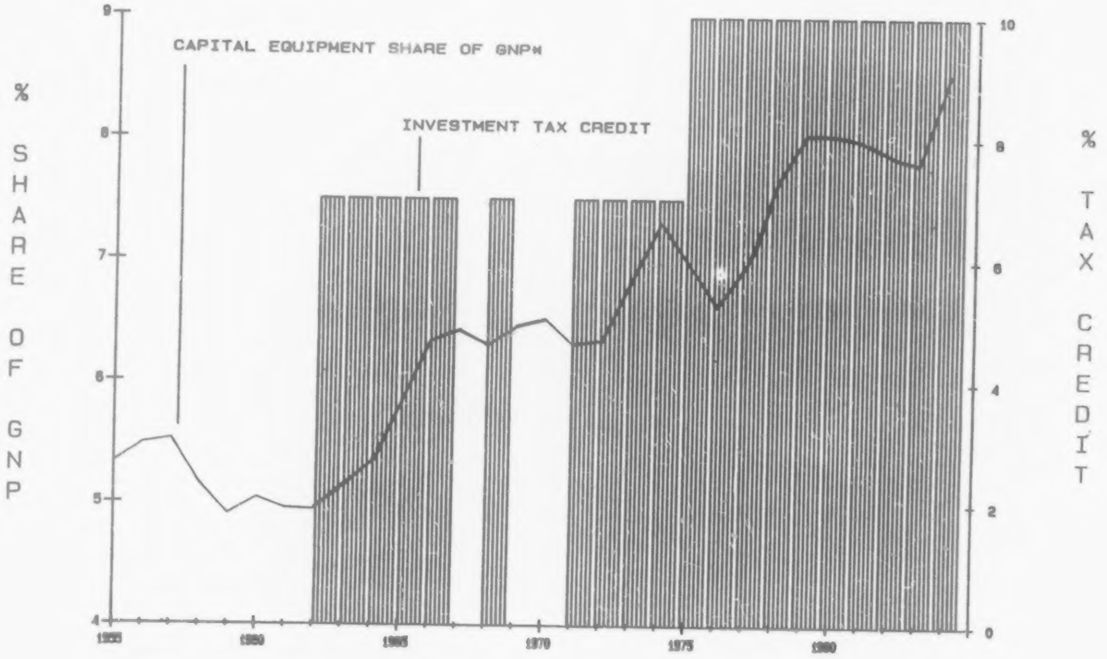
X. CONCLUSION

In many respects the U.S. machine tool industry stands at the crossroads. The directions we choose will, in large measure, be determined by the outcome of this debate. We hope that our comments this morning have underscored the proposition that fundamental changes in tax policy must not be evaluated in a vacuum. We urge you not to ignore the fact that this country is facing a crisis with regard to its international competitive standing. NMTBA members -- large and small -- would be delighted to pay lower tax rates since most pay relatively high effective tax rates today. But we urge this Committee to carefully consider the profound implications of discarding incentives geared toward providing greater capital investment, greater productivity and greater international competitiveness.

We can all agree that achieving fairness and simplification in tax policy are laudable objectives. But there is nothing simple or fair about lower investment that lengthens unemployment lines. It is neither simple nor fair to reduce productivity and make us even less competitive at home and abroad.

EXHIBIT 1

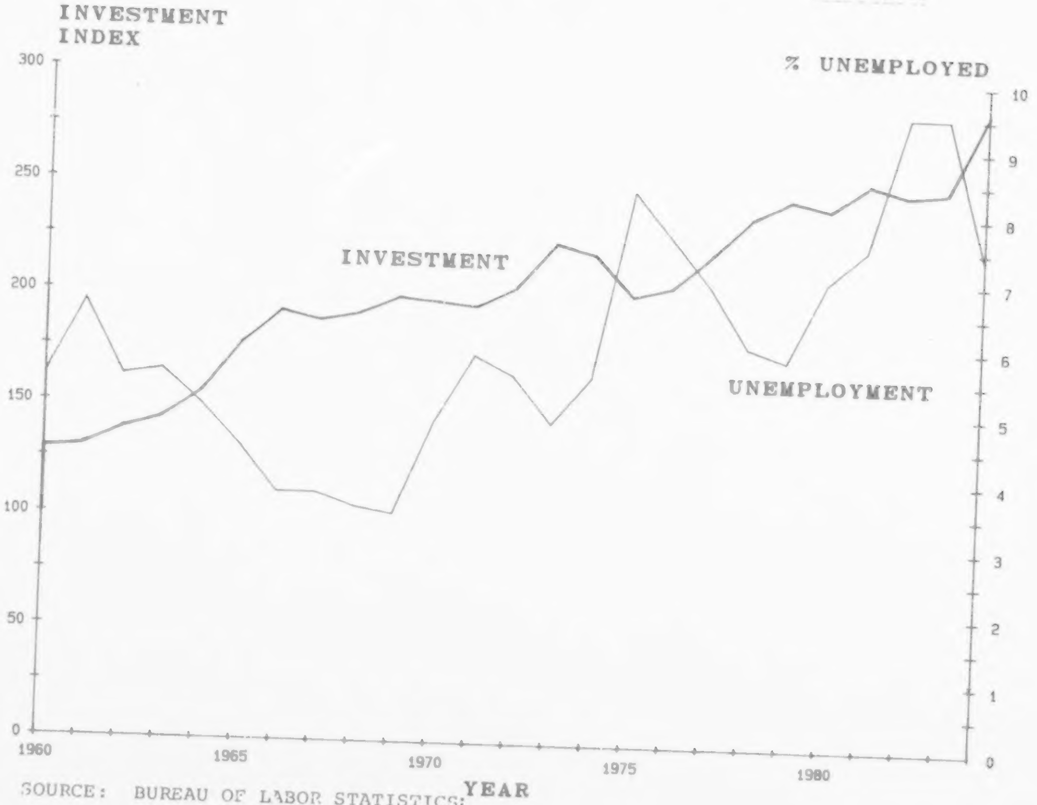
INVESTMENT IN CAPITAL EQUIPMENT AND THE INVESTMENT TAX CREDIT



SOURCE: U.S. DEPT. OF COMMERCE

* – TWO-YEAR MOVING AVERAGE

EXHIBIT 2



SOURCE: BUREAU OF LABOR STATISTICS;
U.S. DEPARTMENT OF COMMERCE

TAX BENEFIT OF VARIOUS CAPITAL COST RECOVERY OPTIONS RESULTING FROM THE PURCHASE OF A $100,000 MACHINE TOOL[1]

Year	ADR SYSTEM (Pre-1981)[2]	ACRS (Current Law)[2]	RCRS (Treasury I)[3]	CCRS (Treasury II)[3]	W & M Staff	W & M + Min.Tax[4]
1	$13,938	$14,988	$ 2,100	$ 3,850	$ 3,750	$ 1,785
2	7,874	7,315	3,848	6,853	7,812	3,571
	$21,812	$22,303	$ 5,948	$10,703	$11,562	$ 5,356
3	6,563	6,983	3,486	5,345	7,032	3,571
	$28,375	$29,286	$ 9,434	$16,048	$18,594	$ 8,927
4	5,250	6,982	2,768	4,169	6,152	3,571
	$33,625	$36,268	$12,202	$20,217	$24,746	$12,498
5	3,938	6,982	2,735	3,696	3,627	3,627
	$37,563	$43,250	$14,937	$23,913	$28,373	$16,125
Year in which $35,000 is recovered[5]	5	4	18	8	8	($27,006 is recovered in Year 8 - thus providing a negative rate of return)

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[1] Assumes 35% corporate tax rate

[2] Includes 10% ITC (10% salvage value under ADR; 5% basis adjustment under ACRS)

[3] Does not include indexing for inflation

[4] Minimum tax provides 25% tax on excess depreciation over straight-line

[5] $35,000 is equivalent to full depreciation at a 35% corporate tax rate

10/1/85

Senator SYMMS. Senator Pryor.

Senator PRYOR. Thank you, Mr. Chairman. I found all of these three statements very interesting this morning. I don't know that I have heard any of the gentlemen this morning comment on something that the President has in the last couple of months stated over and over again: that new jobs are out there, that they are being created—almost, it seems like, on a daily basis—and Mr. Koontz, because you were the last speaker, I wonder if you might address yourself for example—is your home State New Hampshire? Is this correct?

Mr. KOONTZ. Yes, Senator.

Senator PRYOR. What about the State of New Hampshire? This is one of our smaller States. Are new jobs being created in the State of New Hampshire, more specifically in your line of trade, and more generally over the State and throughout the economy, to the best of your knowledge? Are they being created?

Mr. KOONTZ. Senator, it is certainly a good question and one of great concern to me. The President has continued to talk about jobs being created. Keene is much like many thousands of small communities in the United States. Unemployment is about 3 percent, which sounds good on the surface. But many of the manufacturing companies that have provided a livable wage in the past are disappearing. We are one of the very few that are still hanging in there, although our employment is down some 20 percent. Many manufacturing companies—several fastener companies, other basic manufacturing companies—are disappearing. In the case of Keene, they are being replaced by several discount grocery stores and some very good jobs in restoring a couple of mills into stores selling goods, mostly imported. The jobs will be in the $4 and $5 an hour category. There are certainly want ads in the paper every day for jobs, but I can't see where any of them are going to support a family. Most of them do not have fringe benefits, so it means they hit the welfare rolls as soon as they have a problem, whether it be medical or whatever. I am concerned that we are going to have to do something about capital formation in order to keep our basic manufacturing plants alive. No one is going to be paying taxes at $4.00 or $5.00 an hour. That is what I am concerned with.

Senator PRYOR. So, the jobs then that you are aware of that are being so-called created are jobs that have been lost in the private sector in the last several years, and they are taking much less in their take-home pay from what they were in their previous field. Is this correct?

Mr. KOONTZ. Very definitely. Most of our employees are middle-class employees. The jobs we have in my plant would give a worker at least $20,000 to $30,000. The new jobs pay less than $10,000. And the way the tax laws are going, the workers won't even be on the tax rolls in the near future. I don't know how that is going to create taxes to reduce the deficit.

Senator PRYOR. I wonder if there are other of our panel members this morning that would like to comment on the issue of the creation of new jobs that has been raised by the President?

Mr. LAIMBEER. Senator, we would like to think of the paper industry as a growth smokestack industry. We invest more than our cash-flow in new equipment and new machinery to keep our mills modern. We feel that we have the opportunity to export increasing amounts of our product around the world, which will create meaningful jobs in this country. We are worried, though, that this cash-flow that we have reinvested in our business, is in danger now and that the proposals by the administration will reduce that cash-flow over the next 4 or 5 years by $4 billion.

Senator PRYOR. Our State, the State of Arkansas, is a timber producer and thus a part of the paper industry, and I hope a significant part; and I know today that the number of employees in that particular industry are down significantly over what they were 4 years ago. My point is this: I keep hearing the President talking about the new jobs that are being created. I am trying to identify where those jobs are, what they are, and whether they are the types of jobs that these people have had in the past, or they are different—they are down-scaled or up-scaled, or whatever, and that was why I addressed that question to Mr. Koontz. Do you see new jobs today being created?

Mr. LAIMBEER. I see new jobs today being created, once we restore the ability of the American paper industry to export and increase our export. Lately, because of the high dollar, our exports, unfortunately—especially in linerboard, which is a big part of the production in your State—have decreased. We see export markets coming back as the dollar is restored to its right value. Exports will increase.

Senator PRYOR. Mr. Chairman, if I may ask one more question on this same line that deals with our Canadian imports?

Senator SYMMS. Yes, go ahead.

Senator PRYOR. Now, you discussed this but very briefly in your opening comments, and I am wondering if you have done any sort of a study or if you have any sort of an analysis that you might present to this committee relative to the Canadian imports of timber into our country as to how it has affected the American paper industry.

Mr. LAIMBEER. I really don't see much effect there. We, of course, buy timber from the timber side and buy chips to make the paper from—and they have definitely been affected. I believe this Senate committee has been considering that.

Senator PRYOR. Correct.

Mr. LAIMBEER. I believe that the tax reform proposals that we are seeing will tilt the playing field even more in favor of the Canadians; and therefore, I would like to encourage you to consider that.

Senator PRYOR. I am astounded by the figures you presented here in making your case about the number of jobs that might be lost and also what it would do should the present tax reform measure that is before our committee be passed into law. And I appreciate very much your comments.

Mr. LAIMBEER. Thank you, Senator.

Senator SYMMS. Senator Baucus, any questions?

Senator BAUCUS. Yes, just a brief question, Mr. Chairman. Mr. Koontz, what has happened to the machine tool industry in this country? Why are we in trouble?

Mr. KOONTZ. There are a lot of reasons obviously.

Senator BAUCUS. What is one of the most important?

Mr. KOONTZ. One of the most important ones is the targetting a few years ago by the Japanese of a very specific part of the industry—lathes and machining centers. They initially targetted 40 percent of the total market. They were very much after anything they could turn into a commodity. At the point they achieved their goal, they went after 50 percent of the market which they have now acquired. Other parts of our business–are affected because—of what has been done to our customer base. In other words, Caterpillar and other off-the-road tractor manufacturers, were a major market for our industry. This part of our customer base has been literally nonexistent for the last 5 years—anything related to the farm. Part of our customer base has moved offshore. So, it has been a combination of the Japanese attacking a portion of the machine tool business and also attacking our customer base which has forced them offshore. It has been a major problem.

Senator BAUCUS. How should we respond? What should the U.S. response be, by industry and by the Government?

Mr. KOONTZ. Obviously, the first reaction is to certainly not make it any worse by reviewing investment incentives such as the ITC and accelerated depreciation. There are nontax issues, of course. If the dollar gets to be much more in line with the yen and a few other foreign currencies, we are going to have a better shot at exports. But what I am trying to say is, don't make it any worse. I think we can recover if we don't cut off the current incentives that we have. This industry can recover, given time. I guess the dollar doesn't necessarily relate to taxes; but if it is on an equal basis, we will begin to recover.

Senator BAUCUS. Let me ask each of you. How important is it to your business to have the Congress and the President significantly reduce the Federal budget deficit this year?

Mr. KOONTZ. How important is it?

Senator BAUCUS. Yes.

Mr. KOONTZ. I think it is probably the most important issue that we face.

Senator BAUCUS. Would you all basically agree with that?

Mr. ZODROW. Yes.

Mr. LAIMBEER. Yes.

Senator BAUCUS. Next question: What price are you willing to pay to accomplish that result? That is, increased corporate taxes, and or higher individual taxes, along with reductions in spending? What price are you personally willing to pay? What price do you think business is willing to pay in order to achieve a significant deficit reduction?

Mr. KOONTZ. I think, if you are asking me, there is a price we are willing to pay. I am not sure what that is. It all relates again to capital formation and our ability to be competitive and remain competitive, no matter what the circumstances are around us—whether the dollar is up or down. There is some figure.

Senator BAUCUS. One question is to what degree you believe that the deficit is a function of today's receipts versus today's expenditures versus the degree to which you agree with the argument that a bigger deficit is OK as long as it results from big reductions in revenue because, on down the road, the deficit is going to shrink? Which school do you belong to?

Mr. Koontz. Senator, I am going to pass that to my colleague. Do you have anything to say, Jim?

Mr. Mack. Senator, I am not sure that the Congress as a whole has done everything you can to reduce spending. I think that undercutting what the Senate did on the budget last time, was wrong. You would have been further ahead is most of what the Senate enacted in your budget resolution had been the resolution that ultimately passed the Congress. I guess from the perspective of the NMTBA, we would like to see you milk as much out of the spending side as you can before you go to look at increasing taxes. The problem with the particular tax proposal you have in front of you is it shifts $214 billion from individuals to business. Most of that falls on the manufacturing sector. We expected to pay a toll charge, but we are being asked to buy the whole bridge.

Senator Baucus. I see my time is up. Mr. Chairman, I would like to ask one more quick question here. We all want to reduce the deficit. We all think it is at the top of our list. There is some argument about how much more can be done via spending reductions. We have cut a great deal in domestic discretionary spending. The increases in defense spending have begun to come down but we have not reduced non-means-tested entitlements. Some say we should reduce entitlements. I, personally, think that we should reduce all Federal spending across the board, but let's put that aside just for a moment. If you are convinced that we have cut spending about as much as we can—I will make that as an assumption—my question then is: How far are you or is business willing to go in paying higher taxes, corporate and/or individual, in order to further reduce the budget deficit? Zero or significantly or where?

Mr. Koontz. We do promote some sort of tax, as when we talked about the business transfer tax, so we are talking five percent or some figure such as that.

Mr. Mack. But don't do it the way that the President's proposal does it. Although it is revenue neutral, as I said, virtually the whole load falls on the manufacturing sector; and all that is going to do is make us less competitive. To the extent that jobs are going to be created, they are going to be the kind of jobs Mr. Koontz was talking about in the converted mill that is now some kind of a shopping mall.

Senator Baucus. So, the answer to the question is you are willing to pay more taxes, but only in a way that doesn't disproportionately adversely affect the manufacturing sector.

Mr. Koontz. Adversely affect the technology and research and development and our innovation and our competitiveness which means don't cut the incentives.

The Chairman. Senator Symms.

Senator Symms. Mr. Zodrow, you are the only witness who supports the concept of the bill. The other two witnesses, represent the manufacturing and resource end of the economy, which would pay a heavy price if this bill were to pass in its current form they talk about reduced jobs and reduced activity. The mining industry testified that 400,000 jobs would be lost in the mining industry alone if the bill were passed in the form devised by Treasury. What do the people in your industry think will happen to the amount of equipment, produce, lumber, and so on, if the tax bill passes? How can a trucking company, benefit, even if they got a lower tax rate, if there is less to haul?

Mr. Zodrow. That is a very valid concern that we all have. Our industry depends to a great extent on the health of the rest of the country and on the economy as a whole, so you have to look at what will this bill do for the economy as a whole and not just for this industry or that industry that may—another thing we should keep in mind is that we are testifying from an unusual viewpoint. We are a 38-percent taxpayer. If all the taxpayers in this country were paying 38 percent, we wouldn't have these problems that we are talking about here today. So, our point of view is a little bit distorted. We have a large number of employees that we continue to employ, even though we are paying a 38-percent tax rate.

Senator Symms. How is the health of the trucking industry right now?

Mr. Zodrow. Not all that good, but for a little different reason. You gentlemen all know specifically of the change that has taken place in terms of deregulation in the last 5 years or so in our industry; and it is making some very severe changes in how we do business. And it is forcing us to get better, get smarter, work harder, employ the right people; and I suspect that a lot of the problem that we have in our distortion between the high taxpayers and the low taxpayer companies is because it is easier to take on the additional impact and the additional cost if the Government is there to give you a reduced tax or a special provision relating to you. We think that the tax law should be structured to make it more fair, to eliminate the inequities that exist in terms of special interests and in terms of special provisions.

Senator Symms. Thank you. Mr. Laimbeer, you summarize the impact of the President's tax proposal on the paper industry: 180,000 fewer jobs, $4 billion loss in payrolls, and so forth. That is pretty devastating. Has the paper industry studied how much the President's tax bill will really benefit the Treasury? The Treasury always comes over with numbers and talks about how much it will raise if they take away these tax benefits. But have you done a study to show how much it will actually benefit the Treasury so that we can have figures when we start this markup. Then we can actually demonstrate and quantify the numbers to point out that the static number counting that goes on in the Joint Tax Committee and Treasury—is inaccurate. It really costs more to give up some of these things? You know, how do I back up that statement?

Mr. Laimbeer. Our model would show that the Government would lose $1.2 billion in income taxes; but more important, I think, are the losses that will occur at the State and local level in payroll taxes. We will be adding people to our payroll, and they will pay taxes.

Senator Symms. So, then, your model does show $1.2 billion loss in personal and corporate income taxes. How much would it be in property taxes, or do you have a number on that?

Mr. Laimbeer. In property taxes? No; I don't think we do have that.

Senator Symms. Who did the model?

Ms. Pace. I did.

Senator SYMMS. All right. Thank you very much. I think that this is very important information. Many studies of economic models are coming in, and I think we need to get those together. I don't think it is really the intention of the President to have a tax bill that is going to end up gutting manufacturing and resource production. I have said to the chairman many times: This bill looks like it is aimed right at the heart of Idaho. If the bill passes in its current form, Idaho industries will have their taxes raised. Now, we like the part about lowering the rates. I agree with the truckers on that. It would be nice to lower the rates, but that is about where I lose my enthusiasm.

Mr. LAIMBEER. Senator, we will give you more information on our model.

Ms. PACE. If you need more information, we have it.

Senator SYMMS. Thank you.

The CHAIRMAN. Mr. Zodrow, a quick question. In response to Senator Symms, who said, "How is the trucking industry doing?" and you said a few things. And then you said, of course, with deregulation—and I think I wrote it down--"We have had to get tougher, smarter, better." Is that good or bad?

Mr. ZODROW. That is good, and we should have been doing that before.

The CHAIRMAN. So, deregulation was what pushed you to that?

Mr. ZODROW. It has caused more distortion than I described. There is a great amount of distortion. But yes, what is good is we are having to work harder.

The CHAIRMAN. Good. [Laughter.]

I like that answer. I am not going to pursue that one any more.

Senator PRYOR. Mr. Chairman, I suggest that you frame that answer. [Laughter.]

The CHAIRMAN. Now, let me move to Mr. Koontz. I don't know if this was in reply to Senator Pryor or Senator Baucus, but you said the Japanese targeted the machine tool industry. Is that what you said?

Mr. KOONTZ. Yes, Senator.

The CHAIRMAN. What do you mean by "targeting"?

Mr. KOONTZ. Basically, they took after a segment of the market. From our viewpoint, the Japanese were really looking for things that they could turn into commodities. They really weren't interested in products which require a high degree of engineering input. They targeted that segment of the machine tool industry that was very capable of being put into a production type basis as Japan, Incorporated. Our companies did not have that particular capability at that point, either due to antitrust laws or the desire of the individuals not to collaborate in consortiums. Therefore, they targeted at a weak position, which also satisfied their government's plans to make commodity products. They came after us. And I will admit that segment of our market was the weakest because of antitrust laws and a few other things. There was really no effective U.S. reaction to it. And that was what started the ball rolling.

The CHAIRMAN. Let me make sure I am following you. They looked at our market and they said: We think here is where American manufacturers have a weak spot. They are not covering this hole, and we are going to concentrate on that.

Mr. KOONTZ. That is correct, sir.

The CHAIRMAN. Is there anything wrong with that?

Mr. KOONTZ. Not necessarily, except for the way they went about it. We did not have the defenses, due to antitrust laws, to combat that particular problem at the time. A case in point: Houdaille Industries documented the targeting and some of the practices which the Japanese engaged in, which were not necessarily ethical. Houdaille brought their case to the administration.

The CHAIRMAN. That is what I want to get at. You are saying that some of the targeting they undertook involved use of unfair trade practices.

Mr. KOONTZ. That is right, Senator.

The CHAIRMAN. All right. Are significant wage differentials in and of themselves an unfair trade practice?

Mr. KOONTZ. No; sir.

The CHAIRMAN. Should we protect industries in this country where the principal harm is caused solely by large wage differentials?

Mr. KOONTZ. No, I don't think that is what we are aiming at.

The CHAIRMAN. If the principal problem of the textile and the apparel industry is large wage differentials and we cannot compete with Singapore and India and Hong Kong and China, should we protect them?

Mr. KOONTZ. Not purely for wage differentials.

The CHAIRMAN. Thank you. I have no other questions. Senator Pryor?

Senator PRYOR. I have just one followup question, Mr. Chairman, and that is one I will address to Mr. Laimbeer. I think, once again, the table of facts and statistics that you have presented the committee as to your particular segment of the economy on this proposal, on the tax reform, how it will adversely impact the American paper industry. My question is this: Has this adverse impact, has this statement, one, been communicated to the White House? If so, what has been the response from the White House to your concern about the proposal?

Mr. LAIMBEER. Senator, the first part, it definitely has been communicated to the administration, and their response is—and Norma, you might help me in this—but basically, that we should address the issue of jobs and competitiveness overseas through some other means than tax incentives or tax reform. We disagree violently with that, and we believe that it cannot be done that way. It should be done through enabling our industry to invest and to create jobs through the means that we have been doing for the last several years.

Senator PRYOR. I just think, once again, if this tax bill is going to do that to your particular industry, and I know our friend from the trucking industry might have a different area of concern. He has mentioned a few reservations. In effect, he has also endorsed the President's concepts here, which certainly he has that right; but I think that those industries in America and those segments of the economy that are going to be impacted, should this proposal pass, I just urge you to direct that attention and that communication to the White House and the so-called powers to be. To be honest with you, if a Democratic Senator writes a letter to the White House—

or whoever, Mr. Baker, a very fine gentleman—and says, listen, this is really going to hurt the paper industry, well, I will get a cordial response and your views will be considered, but that will be about the end of it. But I think from the industry itself and that segment of the economy that is so adversely potentially impacted, I urge you—I urge you—to try your best to communicate those concerns. Finally, I would like to say, Mr. Chairman, I am going to have to leave. I held five town meetings in August around the State of Arkansas, and I sent everybody a postcard. I said: You all show up at the Holiday Inn or at the courthouse or wherever it might be, and we will have a town meeting and a cup of coffee; and we will talk about the President's tax reform bill. And we had about 250 to 350 at each meeting, and I wandered around with a microphone—I felt like Donahue—you know, and I let everybody have their say about tax reform. And to the best of my knowledge and to the best of my memory after hearing hundreds of people talk about this legislation, Mr. Chairman, with all due respect to the President, I applaud him for taking this issue on; but I don't know that I found one citizen of our State down there who said: Senator Pryor, vote for the President's tax reform as is. I mean, there are a lot of people who applaud the President for taking on this issue, and it is long overdue; but when it comes down to it, there are a lot of people, a lot of parts of our economy that may be a lot worse off if we passed it. And that is why I have got reservations about it, but I thank the chairman for allowing me to go over my time and ask these few questions and make these comments, and I thank these fine gentlemen, too.

The **Chairman**. David, I know what you mean about the town meetings. We have all had roughly that same experience. My favorite one that I have had so far over the year occurred when I was at a coffee shack at a lumber mill and couldn't get much of a response from the audience on tax reform. I finally asked them what they thought about intangible drilling costs, and this one fellow said: If you can't see them, you shouldn't pay them. [Laughter.]

Gentlemen, thank you very much. We appreciate it. Now, if we might have Mr. Furlaud, Mr. Rau, Mr. Riordan, and Mr. Miller. Mr. Furlaud, Senator Mitchell wanted to ask you some questions, and he had to go to another committee meeting. So, he said he would submit some in writing and hoped that you would respond to them.

Mr. **Furlaud**. Thank you, Mr. Chairman.

The **Chairman**. Why don't you start?

STATEMENT OF RICHARD M. FURLAUD, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SQUIBB CORP., PRINCETON, NJ, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. **Furlaud**. Thank you, Senator. My name is Richard M. Furlaud, and I am appearing on behalf of the Emergency Committee for American Trade, or ECAT, an association that represents 61 large U.S. multinational corporations. I am also the chairman of Squibb Corp., a leading pharmaceutical company with $750 million of foreign sales in 1984. Back in 1954, when I was the professional staff member of the Ways and Means Committee—I say "the" because in those days the committee made do with only one special staff member—Congress mandated the use of the per-country limitation in the calculation of the foreign tax credit.

The CHAIRMAN. It mandated what?

Mr. FURLAUD. It mandated the use of the per-country limitation in the computation of the foreign tax credit; and this proved in practice to be a great mistake for the same reason that it would be a great mistake if it were done today. Actually, in 1960, Congress revised the code to permit the elective use of the overall limitation; and then, in 1976, the Congress repealed the per-country limitation entirely and mandated the use of the overall limitation. And now, as you know, the Treasury proposes to turn the clock all the way back to 1954 by repealing the overall limitation and mandating the per-country limitation. Treasury appears to have completely forgotten the history of the section. Let me give you some of the reasons why it was a serious mistake to mandate the use of the per-country limitation in 1954 and why it would be an even more serious mistake today. First, the per-country method of calculating foreign tax credits is divorced from commercial reality. The proposed per-country rule conceives of the modern international business as a compartmentalized organization, computing profit and loss and effective tax rates on a country-by-country basis. This concept was out of touch with reality in the 1950s and is even more unrealistic today. Today's international manager plans and invests at the worldwide, not the country-by-country, level. Thus, it is worldwide taxes, not country-by-country taxes, which are relevant to the avoidance of double taxation. The second reason is that the per-country limitation departs from international practice and would place American firms at a severe competitive disadvantage. The administration's per-country proposal is apparently based on the mistaken belief that a per-country limitation is consistent with international practice. Congress should clearly understand, however, that the per-country approach is not the international norm. Through a variety of means, virtually all countries achieve the effect of the overall limitation. Japan, for example, uses it outright. Were the Treasury proposal to be adopted, the United States would stand virtually alone in prohibiting its international businesses from using worldwide tax rates to avoid double taxation. The third reason is that the per-country proposal is extraordinarily complex to administer, which is one of the reasons why it did not work in the past. The administrative cost, the uncertainties, and the complexities of the administration's proposal are very serious concerns to large companies such as mine, but they could be crippling to smaller businesses. The fourth reason is that it is unclear what so-called perceived abuse the per-country proposal is intended to remedy. Treasury argues: "The averaging permitted by an overall limitation gives taxpayers with operations in the high tax country an incentive to invest in a low tax country." But in the real world, business factors overwhelm tax considerations in the decision whether to commence operations abroad. Let me illustrate. According to a 1981 U.S. Department of Commerce survey, less than 5 percent of U.S. foreign manufacturing investment and less than 2 percent of U.S. foreign investments overall was located in low tax jurisdictions. Stated otherwise, all but a very small portion of American foreign investment is made in countries with tax rates comparable to or higher than those in the United States. In my view, this statistic alone proves that the Treasury cannot make the case for abusive Tax Code investment abroad. I would also like to say in passing that, although I am addressing this testimony to the Treasury's foreign tax credit proposal, I am advised that the Ways and Means Committee is now considering another proposal. This one consists of an incredibly complex series of new foreign tax credit rules which appear to be even more deleterious in terms of their effect on American competitiveness than the Treasury's already bad proposal. Indeed, the proposal before the Ways and Means Committee, while ostensibly retaining the overall limitation, appears to amount to a restoration of the per-country limitation by the back door, so to speak, and in an even more punitive and complex form. Getting back to the Treasury's proposal——

The CHAIRMAN. I will have to ask you to wind down, Mr. Furlaud.

Mr. FURLAUD. I will wind down, sir, by simply saying that the Treasury's proposal is a very, very bad idea. And you know, there are so many opportunities to make new mistakes in the tax law, why go back and make an old one? [Laughter.]

The CHAIRMAN. There was only one staffer when you were there?

Mr. FURLAUD. Yes, sir.

The CHAIRMAN. And you were it?

Mr. FURLAUD. I was it. There was a clerk of the committee on the majority side, a minority advisor on the minority side, and one professional staff member, and I was he.

The CHAIRMAN. And however many lobbyists there were at that time, if they came to a staffer, they came to you?

Mr. FURLAUD. Well, I was quite busy of course. [Laughter.]

The CHAIRMAN. Mr. Rau.

[The prepared written testimony of Mr. Furlaud follows:]

TESTIMONY OF RICHARD M. FURLAUD ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

SUMMARY

* The Administration's per country foreign tax credit proposal is divorced from commercial reality. Modern businesses are run on an integrated, worldwide or regional basis; they are not artificially segmented country-by-country. Thus, it is worldwide and regional taxes, not country-by-country taxes, which are relevant to the avoidance of double taxation.

* The per country proposal departs from prevailing international practices, which would place American firms at a severe competitive disadvantage. Japan, for example, uses the "overall" approach the Administration would abandon.

* The proposal introduces administrative costs, complexity, and uncertainty at an unprecedented level. This is of serious concern to large companies, but could actually exclude smaller companies from the international marketplace.

* The "abuses" the proposal supposedly addresses are illusory. American firms invest abroad for business, not tax, reasons. Moreover, such investment is vital to the health of our domestic economy.

* Congress has repeatedly supported the "overall" approach to foreign tax credits as the correct and proper method of avoiding double taxation. Congress reaffirmed its support as recently as 1976, in conjunction with a recommendation from a Ways and Means Task Force chaired by Congressman Rostenkowski.

* The revenue projections for the proposal are greatly overstated.

* Other proposals made by the Administration, such as the suggested changes to the sourcing rules, would also hurt our international competitiveness.

TESTIMONY OF RICHARD M. FURLAUD
ON BEHALF OF THE
EMERGENCY COMMITTEE FOR AMERICAN TRADE

My name is Richard M. Furlaud, and I am appearing on behalf of the Emergency Committee for American Trade, or ECAT, an organization that represents 60 large United States corporations. ECAT's purpose is to support measures that expand international trade and investment. The members of ECAT conduct business in virtually every market in the world in competition with corporations from Japan, Germany, South Korea, and other countries. Companies represented by ECAT have combined annual sales in excess of $700 billion, and employ over 5 million people.

I am also the chairman and chief executive officer of Squibb, a leading pharmaceutical company with foreign sales in 1984 of $750,000,000. My company competes in 41 countries against strong, and in some cases much larger, pharmaceutical and chemical companies from Germany, Switzerland, France, the United Kingdom, and Japan.

I am here today to express my concern -- even alarm -- with the Administration's proposal to abandon the longstanding method employed by the United States to calculate the foreign tax credit, and thus avoid double taxation. The foreign tax credit is designed to ensure that American companies pay the higher of either -- but not both -- the U.S. tax rate or the foreign tax rate on income earned abroad. Foreign tax credits cannot be used, however, to avoid or reduce U.S. taxation of income earned domestically.

The Administration's proposal is explained, in technical terms, as a change from the "overall" limitation on foreign tax credits to a "per country" limitation. Let me say first that this proposal makes little economic sense. It will impose needless burdens on American industry abroad, and in the process further weaken America's international competitive position.

The stated purposes of the Administration's tax proposals are to promote fairness, economic growth, and simplicity. Yet a shift from the overall limitation would frustrate each of these goals. The proposal would force American companies to compute tax liabilities in an unfair manner completely divorced from commercial reality. The proposal also would depart from prevailing international practices, placing American firms at a competitive disadvantage and impeding growth. Finally, the proposal would introduce administrative complexity and costs at an unprecedented level, resulting in rules that in the final analysis will be arbitrary and artificial, and which could bar all but the largest U.S. companies from entering the international marketplace.

Indeed, the proposal departs so markedly from the Administration's goals that it can be understood only as a last-ditch attempt to preserve a facade of revenue neutrality. In other words, the proposal is nothing more than a five year, $13 billion surtax -- you could even call it a penalty and not be wrong -- imposed on America's foreign business operations.

The Treasury seeks to justify its proposal by suggesting that the per country method is the accepted and proper method of calculating foreign tax credits. This attempt to occupy the "high ground" in this debate is misleading. Virtually all of our major competitors employ the overall limitation or a method of avoiding double taxation which achieves the same result. Just as important, Congress itself has repeatedly supported the overall limitation as the proper and correct method of avoiding double taxation.

The Treasury also seeks to justify its proposal by suggesting that the overall limitation leads to excessive, tax-motivated investment abroad. This argument is also misguided. My company, for example, operates abroad for business reasons, not tax reasons. Almost every country has its own version of a food and drug administration, which all but forces pharmaceutical companies to do business "in-country." Exorbitant tariffs also require us to operate abroad if we are to compete for foreign markets with the large European and Japanese drug firms. In other words, if Squibb is to tap British, French, German and other European markets, it must be inside Common Market tariff barriers and subject to local food and drug rules. So the Treasury's assumption that tax rules are at the center of our decision to invest abroad is wrong.

Before discussing these matters in more detail, I would like to register my support for the continuation of the moratorium on the Section 861 rules as they apply to research and development. Many of you have already sponsored legislation of this sort. I feel it is appropriate to mention this issue here because it is directly related to what I hope is the continuing policy of the United States -- that is, the avoidance of double taxation in international trade.

I also would like to mention ECAT's support of the current Section 936 rules -- not the Administration's proposals -- concerning the taxation of U.S. possessions.

Finally, I should note that, although I will emphasize the Administration's per country proposal, other proposals affecting international trade, such as the Administration's suggested changes to the sourcing rules, and other proposals generally, such as the proposed elimination of the investment credit, will adversely affect our international competitiveness.

I. The Administration's Per Country Proposal Misconceives the Organization of Modern International Business

In expanding upon the points I made above, I want first to address the fact that the per country method of calculating foreign tax credits is divorced from commercial reality.

Today's international manager plans and invests at the worldwide and regional level, not country-by-country. The proposed per country rule, however, conceives of the modern international business as a compartmentalized organization, computing profit and loss and effective tax rates on a country-by-country basis. I doubt that this state of affairs has ever prevailed, and it certainly does not prevail today. International boundaries have little business significance in a world where one component of a product may be produced in the United States and another in France, with warehousing in Belgium, asssembly in Germany, and sales in a number of other foreign countries.

Because the modern manager plans and invests at the worldwide and regional level, it is the overall foreign tax rate, not each country's individual rate, that has meaning for business purposes. Protection against double taxation requires that foreign taxes, regardless of the country of imposition, be creditable for U.S. purposes up to the point where the overall tax burden on foreign income does not exceed the United States tax burden on equivalent domestic income. This is precisely the result provided by the overall limitation. If this level of protection is not provided, American operations abroad are penalized and trade is discouraged.

Congress has recognized this fact since 1921, when it established American policy in favor of an overall credit limitation. Congress has reaffirmed this policy many times since. In 1960, for example, it said:

> In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.

S. Rep. No. 1393, 86th Cong., 2d Sess. (1960).

American international business has become more, not less, integrated in the twenty-five years since Congress made this statement.

II. The Proposal Would Depart from International Practice, Placing American Firms at a Severe Competitive Disadvantage

The second point I want to elaborate upon is that imposition of a per country limitation will place a burden on American firms not imposed on their international competitors. The proposed shift to a per country policy originated in the November Treasury report, apparently based on the mistaken belief that "[a]doption of a per country limitation is consistent with international practice." The current version of the proposal drops this claim, although the Administration has not yet dropped the proposal. Congress should understand clearly that the per country approach is not the international norm, and that forcing American businesses to adopt a per country rule will place our firms at a disadvantage with respect to our foreign competitors. For example, because of various incentives, U.S. companies doing business in the United Kingdom frequently have an effective tax rate less than the U.S. rate. Under the per country proposal, the United Kingdom rate would, in effect, be raised to the U.S. rate. Foreign competitors in the United Kingdom would keep their low effective tax rate, however. Thus, the U.S. companies would be forced to compete burdened with a tax charge not borne by their competitors.

Technical practices concerning the taxation of foreign operations vary somewhat from country to country, but virtually all achieve the effect of the overall limitation. Some of our trading partners, such as Japan, Switzerland and Sweden, use the overall method outright. Others, including Germany and France, provide protection against double taxation by generally exempting foreign-source income from taxation. Exempting foreign-source income, like the American overall tax credit limitation, in effect enables French and German international businesses to pay tax on foreign income at an average worldwide rate. Still other countries permit taxpayers to average foreign tax rates through the use of foreign holding companies. The United Kingdom and Canada are two major trading partners that permit averaging through the holding-company method.

If the Treasury proposal is adopted, therefore, the United States will stand virtually alone in prohibiting its international businesses from averaging effective tax rates. If Treasury estimates of the tax cost of the proposal are correct, American companies alone will be forced to engage in international competition with a five year, $13 billion burden on their backs. When added to the hidden subsidies and various protectionist barriers employed by our trading "partners," the potential damage to our international competitiveness should be obvious to all. Operations that will be feasible to our foreign competitors will be prohibitively expensive to American firms. American business will be excluded from these operations and the international markets they represent.

It must be understood clearly that the preservation of American investment abroad is an essential component of a policy to encourage American exports. A recent Treasury study indicates that in 1980, American business exported over $87 billion in products to their foreign subsidiaries. Thus, exports by U.S. parents to their foreign subsidiaries constituted about 40 percent of American's export volume. Reduction of these exports, by impairing the competitive position of American business abroad, will further damage America's export industries and will cost millions of American jobs.

The Administration should be working now to encourage exports, not reduce them by imposing restrictions on U.S. firms that are not imposed on their foreign competitors.

Similarly, profits from American operations abroad provide an important source of capital for investment in the United States. In 1980, payments to the United States from foreign subsidiaries of U.S. companies amounted to over $70 billion. We cannot escape the fact that the American economy is heavily involved in international trade, and that interfering with trade will hurt our domestic economy. American jobs and prosperity require tax policies that encourage, not penalize American operations abroad.

The per country proposal not only departs from international norms but, as mentioned above, departs as well from United States practice for virtually the entire history of our income tax system. When the foreign tax credit was introduced in the United States in 1918, no limitation was imposed. In 1921, the overall limitation was introduced and it remained in effect until 1932. From 1932 to 1960, U.S. law nominally imposed a per country limitation but, as in the United Kingdom and Canada today, taxpayers could achieve averaging through the use of holding companies. In 1960, Congress revised the statute, allowing taxpayers the choice of an overall or per country limitation. In 1976, Congress simplified the Code by establishing the overall method as the only method permitted U.S. taxpayers.

It makes little sense in the current economic environment to depart from both international and longstanding United States practice and require American businesses to operate abroad under a per country regime. The preservation of the American competitive position is as important as it has ever been to United States economic policy. The President's Commission on Industrial Competitiveness this year called for policies that will "[r]educe the domestic obstacles to increased U.S. trade competitiveness, particularly the lack of coherence in policymaking decisions affecting trade," and that will "[m]odify or eliminate regulatory mechanisms that are not based on a global market definition or outlook." In light of these goals, it is absurd now to impose on United States firms a tax credit limitation that is based on antiquated business notions and is more restrictive than the rules imposed on our foreign competitors.

Treasury's explanation of the per country proposal itself suggests hesitation about the competitive wisdom of this approach. After proposing the per country limitation, the report states that "the Administration will consider workable options for calculating the credit on a regional or integrated operation basis if that can be done in a manner consistent with the underlying rationale of the per country limitation." It is difficult to determine the meaning of this statement, but it indicates at least that the drafters of the proposal had doubts concerning the prudence of imposing a strict per country regime. These doubts were well founded. The Administration proposal is out-of-step with the demands of the world market, and its adoption would hurt American industry and American workers.

Also out of step is a suggested compromise that would establish "high tax" and "low tax" baskets. This compromise embodies all of the problems of the "per country" proposal, and creates its own additional problems. Another suggested compromise, requiring "regional" computation of foreign tax credits, is similarly flawed.

III. The Per Country Proposal Is Not Workable

Under the existing overall limitation, businesses are required to divide income and deductions only between domestic and foreign sources. Yet even the division of income into these two categories involves exceedingly difficult allocations of overhead items and other essentially fungible expenses such as interest. The Treasury's 482 and 861 regulations dealing with this subject are even now among the most lengthy and complex of all tax rules, and the foreign/domestic distinction constitutes one of the most regular sources of conflict between taxpayers and the Internal Revenue Service.

I think you all know that we have not been able to decide how to allocate United States research and development expenses between United States and foreign income ever since Treasury proposed the Section 861 regulations. That is why I mentioned my support for a continuation of the present moratorium at the outset of my testimony. The complexities of the Section 861 R&D rules, however, relate only to allocating R&D expenses to the United States -- or abroad. Think how much more difficult this process will be -- and how arbitrary and artificial the rules will be -- when the allocation must be made for all items of income and expense between and among the United States, Britain, Germany, Japan, Brazil and all other countries of the world where American firms conduct business. Moreover, to be fair, the rules would need to permit German R&D and other items of income and expense to be allocated to the United States -- and to the income of U.S. subsidiaries in Britain, Japan, Brazil, and so on.

This example only partially describes the quantum increase in complexity under a per country limitation. The per country proposal will raise complexities unprecedented in kind as well as amount. Most importantly, the foreign tax credit includes a "deemed paid" credit for dividends paid by a foreign corporation to a U.S. shareholder. Under the deemed paid credit, a dividend paid by a foreign corporation is generally considered foreign source income, and the U.S. recipient is allowed a credit for foreign taxes paid on the profits from which the dividend was distributed.

Under a per country limitation, it will be necessary for the foreign corporation to compute the source of its income on a country-by-country basis, so that the American shareholder can then calculate its own per country limitation. The Administration proposal advises simply that "[d]ividends will be sourced for foreign tax credit purposes pro rata to the country or countries from which the payor corporation has derived the accumulated profits out of which the dividend is paid." The actual mechanics of this tracing would, however, involve massive complexity, at a level unknown even in modern tax accounting.

Similar problems would arise where a foreign subsidiary is taxed by its country of incorporation on worldwide income. For a per country limitation to operate properly, taxes should be allocated not to the country to which they are paid but rather to the country in which the underlying income was earned. The Administration proposal mentions the necessity of such allocations, with no treatment of the obvious complexities involved.

The complexity of the Administration's proposal is magnified by its departure from the regional focus of modern accounting practices. Even the most sophisticated of U.S. home offices will need to provide additional personnel and computer resources to perform the large matrices of calculations needed for a country-by-country computation. These additional costs will be serious even for a large multinational operation. They may be crippling for a more modest concern, and the Administration's proposal may well exclude smaller corporations from the international market. This is hardly consistent with a sound competitive policy or with the general goals of the Administration's tax plan.

The per country proposal will impose costs on the federal government as well as the private sector. Each of the new allocations required under the proposal will be a potential source of conflict between taxpayers and the Internal Revenue Service. Additional audit personnel will be required to avoid an administrative logjam that could paralyze the international tax audit process. We can surely find better uses for government revenues than the enforcement of an overwhelmingly complex provision that makes little sense in the first instance.

The Administration admits the practical shortcomings of the per country proposal in its own report, which concedes that the per country limitation will impose "significant new burdens on both taxpayers and the Internal Revenue Service." The Administration's report says specifically:

> Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per

> country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation. The recordkeeping burdens on taxpayers and auditing burdens on the IRS will be correspondingly increased.

This report is very similar to one delivered by a 1976-77 House Ways and Means Committee Task Force on Foreign Source Income chaired by Congressman Rostenkowski. This Task Force recommended exclusive reliance on the overall limitation:

> The per-country limitation requires that a separate computation be made for each country in which a taxpayer operates. Each of these computations requires the taxpayer to calculate the gross income and deductions to be allowed to each country. Since, as discussed above, many large corporations operate on an integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world. These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group.

Committee on Ways and Means, Recommendations of the Task Force on Foreign Source Income, 95th Cong., 1st Sess.

Unfortunately, however, the Administration has failed to heed both its own report and that of the Ways and Means Task Force. We believe this displays a lack of appreciation of the magnitude of the administrative burdens and a cavalier view of their importance. This is not the time to introduce substantial new complexity into the tax laws -- certainly not in the name of simplification and at the expense of U.S. businesses competing abroad.

IV. It Is Unclear What "Abuse" the Proposal Is Intended to Remedy

The Administration proposal argues that "the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries." This statement, if read uncritically, might suggest that existing tax credit rules somehow draw investment abroad from the United States. But the investment affected by the per country proposal is comprised almost entirely of direct United States investment in active business operations. It is extremely unlikely that any differences between the overall and per country limitations would affect investment decisions of this kind.

As a practical matter, business factors overwhelm tax considerations in the decision whether to commence operations abroad. I have already mentioned some of the factors that affect pharmaceutical manufacturing. Other American businesses operate abroad to gain access to foreign markets, gain access to raw materials, reduce transportation costs, provide parts and service in foreign markets, meet foreign regulatory requirements, and pierce "protectionist" economic barriers. Tax considerations will do little to change decisions induced by these factors.

This is perhaps best evidenced by the pattern of United States direct investment abroad. According to a recent U.S. Department of Commerce survey, despite the advantages of investment in low tax jurisdictions, less than five percent of U.S. foreign manufacturing investment -- and less than two percent of U.S. foreign investment overall -- was located in such jurisdictions in 1982. Stated otherwise, all but a very small portion of American foreign investment is made in countries with tax rates comparable to or higher than those in the United States. In my view, this statistic alone proves the Treasury cannot make the case for "abusive," tax-motivated investment abroad.

In addition to the alleged distortion of investment decisions, another purported justification for abandoning the overall limitation is that averaging foreign rates "permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment." The notion here is that when a foreign tax is credited against U.S. tax liability, the U.S. government is somehow "funding" that tax. The Administration expresses the view that if a per country limitation is imposed, foreign jurisdictions "would have a stronger incentive to adopt lower taxes either unilaterally or through the treaty process." In other words, a burden is to be imposed on United States taxpayers now, in the hope that foreign governments will at some point in the future be induced to change their behavior. This approach is perverse and unfair. No other country will be penalizing its companies in the hope that worldwide tax rates will eventually decline, and the first step in a strategy of international adjustment should not be to expose American firms to competitive disadvantage.

If the Administration perceives a need to influence foreign tax policies it can do so without sacrificing American competitiveness. Most notably, the United States maintains ongoing tax relationships with all of its major trading partners through the treaty process. Foreign governments are interested in U.S. tax concessions just as we are interested in foreign concessions. It would appear far more rational to attempt to achieve desired foreign changes on a bilateral basis, rather than by first placing American firms at a disadvantage in the hope that foreign behavior will later change.

V. The Proposal Makes Little Fiscal Sense

Given the shakiness of the policy justifications offered for the per country proposal, the real motivation becomes apparent -- the Administration views the per country proposal as a way of helping to preserve a facade of "revenue neutrality" for the tax plan as a whole. The revenue estimates provided by Treasury, however, are almost certainly overstated. Moreover, any revenue gains must be balanced against the costs of the proposal. In view of the additional administrative burdens and competitive damage the proposal is likely to cause, imposition of a per country limitation is a singularly inefficient way to raise revenue.

The Administration has estimated that imposing the per country limitation will raise revenues of roughly $2 to $4 billion annually. This assumes, however, that the current "tax holiday" jurisdictions will react passively to the proposed change. Any revenue gained from the per country proposal will result from imposing a United States tax on income that a foreign jurisdiction has chosen to tax at rates lower than those applicable in the U.S., in order to achieve its own social and economic objectives. Once the foreign jurisdictions realize that the United States is changing present policy and imposing a tax on this income, the foreign jurisdiction almost certainly will assert its own taxing power. The foreign government's goal, after all, is to forego taxation of the income, not to transfer taxing jurisdiction to the United States. The foreign jurisdictions will view the U.S. move as an encroachment on their sovereignty and will react in kind, so that the purported revenue gains of the per country proposal will largely evaporate.

Any modest revenue that might be raised would be gained at a prohibitive cost. The increased revenues, of course, would not represent real economic gains at all, but would simply represent transfers of the funds involved from private to public use. The additional administrative expenses incurred under the proposal, on the other hand, will constitute real economic losses both to private industry and to the government. Once expended, the resources used to meet these costs will be unavailable for constructive use by either the public or private sectors. It is an elementary principle of public economics that revenue should be raised at the least feasible administrative cost, not the most. The general focus of the Administration's plan on simplicity conforms to this principle, but the per country proposal represents a gross departure.

The inefficiency of the proposal is underscored by the alternative means available to Treasury to achieve the tax result it claims to seek. By reducing foreign effective tax rates through treaty negotiations, the Treasury can lower creditable foreign taxes without increasing administrative burdens and without exposing American firms and exports to competitive disadvantage. It would make much better sense to try this cost-effective route before enacting the current wasteful proposal.

VI. Conclusion

The proposal to impose a per county limitation is unfair and anticompetitive. It will rely on arbitrary and complex rules, and is not justified either by theoretical purity or the spectre of tax-motivated investments. The only possible motivation for the proposal would appear to be to enhance the Treasury's revenue estimates. These estimates have almost certainly been overstated. Moreover, any actual revenue gains will be purchased at the expense of America's competitive position abroad.

The Administration would have been better advised to resist exclusive reliance on revenue estimates and to consider instead the counsel of those who have considered this issue comprehensively in the past. I refer especially to the classic study of the foreign tax credit performed by Elisabeth Owens and published by the Harvard Law School in 1961. Professor Owens concluded:

> The over-all limitation is . . . clearly preferable in terms of administrative simplicity; it provides a greater degree of internal consistency in the tax credit system; and it probably conforms more closely with the attitudes of taxpayers towards the basic problem presented by the simultaneous imposition of foreign and United States taxes.

The need to protect America's competitive position has not diminished since these words were written, and Congress has wisely followed Professor Owens' advice for many years. There is no reason to abandon the overall limitation now. The abandonment of the overall limitation will represent an unjustified and radical departure from past judgment, and Congress should not support it.

STATEMENT OF THOMAS C. THEOBALD, VICE CHAIRMAN, CITICORP/CITIBANK, N.A., ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. Chairman and members of the Committee, I am Thomas C. Theobald, Vice Chairman of Citicorp. I am pleased to appear today on behalf of the Emergency Committee for American Trade to address those provisions of the President's tax reform proposals which primarily affect international trade. In particular, I take this opportunity to express our opposition to the proposed per country foreign tax credit limitation and the proposed new rules for sourcing income.

These proposals would, if enacted, significantly change the terms under which U.S. companies do business abroad. The net effect of both proposals would be to substantially increase the costs to the U.S. companies of doing business abroad, thereby rendering such business far less profitable, and making U.S. companies less competitive, or indeed non-competitive, in world markets.

Briefly, under the Administration's proposal, the per-country foreign tax credit limitation would deny credits for foreign taxes paid to each country to the extent the foreign tax on the net income from that country exceeds the proposed U.S. corporate tax rate of 33%. Similarly, the changes in the sourcing rules would cause certain income now treated as foreign source to be treated as U.S. source, and could treat income as sourced to a country other than the country which actually taxes that income. This would cause further loss of the use of foreign tax credits derived from that country.

These proposed provisions, by increasing the overall tax costs of U.S. multinational companies, would have a serious adverse impact on our foreign trade, the balance of payments and on U.S. jobs. Those negative results would seriously damage the oft-stated and universally accepted policy goals of our government to increase jobs and improve the trade performance and competitiveness of U.S. businesses in world markets.

At a time when U.S. exports of manufactured goods are down, which weakens our national position in markets around the world and thus benefits the non-U.S. competition, these proposed changes in the U.S. tax rules would insure that when exchange rates for the dollar inevitably come more into line with historic norms and the U.S. competitive position improves, we will have placed a new burden on multinational companies when they begin to recover their competitive position. If we are really worried about the U.S. trade position in the world, then we shouldn't build a structural handicap into our multinational business.

Without our multinationals in the picture, the situation would be much worse. Every $1 billion in U.S. exports not only reduces the current account deficit in our balance of payments by $1 billion but also creates 25,000 American jobs. Exports of goods and services directly create some 4.5 million manufacturing jobs and millions more services sector jobs in the United States. At last count over 20 million domestic American jobs were directly tied to American multinational businesses operating here and around the world.

Furthermore, it has been said that if American trade supremacy is to be maintained, it will be through the entry of smaller companies into the international arena. This is the same economic sector that is continually credited with providing the domestic economy with its vigor. If these companies are inhibited from selling their products and services abroad because of tax considerations, it will perforce weaken the employment engine of the domestic economy. In each foreign market, our overseas competitors will strengthen their grip on international business.

In examining the potential adverse impact of these proposed rules on America's foreign trade and domestic economy, the role of U.S. banks is a key element. Financial institutions enter new markets to serve their customers. American banks have vastly increased their overseas business over the last century because American businesses needed us to be there. Citicorp, as an example, has 2,700 banking offices in cities in 92 countries throughout the world.

U.S. banks play a critical role in foreign trade. They finance U.S. exports, from the building of manufacturing plants to the financing of trade credits and other foreign trade financial instruments. They also finance the foreign buyers of American products, thus enabling those buyers to undertake such purchases. Finally, they play a key role in recycling U.S. dollars located overseas back into the U.S. economy, to the benefit and increased strength of our country.

The application of these proposed new tax rules to American banks, as well as to their U.S. customers, will weaken the condition of both. Just as our customers would be less able to compete in world markets, our business similarly would be less competitive. Banks would be forced to alter or cancel otherwise sound business plans because of tax considerations, losing ground to our foreign competitors. Banks and other service businesses now represent an important component of America's trade position. Can we afford to place these kinds of constraints on their growth?

Under a per country limitation, American businesses which operate in the international marketplace would be placed at a severe disadvantage vis-a-vis their foreign competitors. No other nation employs a foreign tax credit limitation method as onerous as the Administration's proposal.

Therefore, it is crucial to the health of the U.S. economy and its foreign trade that the present overall foreign tax credit limitation method be retained. Since the beginning of the foreign tax credit system in this country in 1918, there has been extensive discussion of how to treat income earned abroad. Congress has alternated between the overall method and the per country method of limitation. Since 1960, it has been Congressional policy that since American companies conduct business abroad on an integrated basis, it is appropriate to calculate the foreign tax credit limitation in a similar manner, i.e., under the overall method. Thus, the overall limitation recognizes that the income from integrated operations overseas should be subject to an averaging of high and low taxes from all countries in which the operations are conducted.

The overall limitation permits American corporations to make decisions about the markets they will enter and the customers they will seek for pure business considerations such as the local need for products and services, sovereign risk, the quality of the work force and local communication and transportation facilities. Because of the ability to average foreign taxes through the use of the overall limitation, relative foreign tax rates heretofore have not been a dominant concern. Under the per country limitation, tax considerations would leap to the forefront and would weaken our competitive position in some of the most important markets in the world — the United Kingdom, West Germany and Japan, to name a few.

It seems clear that the primary goal of the Administration's new per country limitation proposal is to increase tax revenues. However, the projections of revenue are based on a static view of the market. Markets are dynamic. The short-term gain from enactment of this proposal would be offset by long-term losses. With the pace of the market we have become accustomed to, it wouldn't be very long before the per country limitation and the new source of income rules would begin to take their toll on American trade performance and competitiveness.

This, in turn, would take its toll on domestic employment and economic growth. For whatever merit there may be in the other provisions the Administration's tax proposal, we urge that these foreign provisions should be dropped.

SUPPLEMENTAL COMMENTS

These comments supplement the testimony of Thomas C. Theobald, Vice Chairman of Citicorp, appearing on behalf of the Emergency Committee for American Trade before the House Ways and Means Committee on July 12, 1985. They are intended to illustrate the effects of the proposed per country limitation and changes in the source of income rules on international transactions of U.S. multinational banks.

It is submitted that the overall foreign tax credit limitation method rather than the per country method furthers the Administration's stated objective that investment capital should gravitate to where it will yield the optimum economic return unencumbered by tax restrictions. One of the key functions of a multinational financial institution is to intermediate funds in order to produce the maximum economic good primarily for the United States, as well as for the global trading community. If U.S. banks are forced to consider the impact on their foreign tax credit position every time a multinational transaction arises, disintermediation is bound to occur.

In a broad sense, funds intermediation includes the financing of trade receivables. A foreign branch of a U.S. bank under the proposed changes would find it less conducive to factor trade receivables of foreign sales subsidiaries of U.S. manufacturing companies (where the goods were originally manufactured in the U.S.) or finance sales of goods originally manufactured in the U.S., especially if the goods are to be sold in high-tax, thick-market countries. This would restrict funds transfers and adversely impact U.S. manufacturers who depend almost exclusively on U.S. banks for export financing.

Under the Administration's proposal, the per country limitation appears to be based on the assumption that items of foreign income and the related foreign taxes imposed thereon are sourced to the same jurisdiction. This frequently would not be the case. The interplay of the proposed U.S. source rules and local foreign tax rules can result in a "mismatching" by country where the income is earned and the country which assesses the taxes. Under the proposal, interest (the principal component of a bank's income) would not be sourced to the country where it is paid, nor to where funds are used, but to the place of incorporation of the payor. This sourcing rule in many cases would not be followed by foreign tax authorities. This mismatching would be particularly critical for financial institutions.

Mismatching would occur if a foreign branch of a U.S. bank located in one country extends credit to a foreign sales subsidiary of a U.S. manufacturer in another country. Interest on the loan would be sourced to the sales subsidiary's country of incorporation but the taxes would be allocated to the country in which the branch is located. Under the present overall method this type of financing does not present a foreign tax credit problem. However, under the per country method, this mismatching would result in a permanent loss of foreign tax credits and in many cases would make this type of financing unfeasible for U.S. banks.

U.S. banks frequently will make a cross border loan because of local country regulatory restrictions. For example, Indonesia prohibits local banks (including local branches of U.S. banks) from providing borrowers with U.S. dollars but will allow offshore entities to lend U.S. dollars to Indonesian borrowers. U.S. banks which would otherwise extend cross-border credit in this type of situation might not do so because of the mismatching problem created by the proposed rules.

The multi-currency credit line is another typical international financing transaction which U.S. manufacturing companies arrange with U.S. banks. The purpose of the credit line is to allow a U.S. manufacturing company's overseas branches or subsidiaries to draw down amounts when necessary to finance local country sales of U.S. manufactured goods. Here, too, there exists the potential for mismatching of foreign income and tax. Because of the per country limitation, a U.S. bank may decide it is simply not economically feasible to do the financing.

A direct effect of the proposal would be the loss of overseas, short term deposits with U.S. banks to their foreign competitors. Every day excess funds of foreign subsidiaries of U.S businesses, as well as foreign branches of U.S. corporations and banks, are placed on deposit with foreign branches of U.S banks for very short terms (i.e., 1 to 7 days). Under current law, foreign branch deposit interest is foreign source income. However, under the Adminstration's proposal, the interest would be treated as U.S. source income but may carry a foreign tax with the result that the per country limitation may prevent the foreign tax from ever being used as a credit. This would discourage U.S. multinational corporations from placing deposits with foreign branches of U.S. banks; instead, to ensure proper matching of foreign income and foreign tax to a particular jurisdiction, the customers of the U.S. banks would have to place their funds with foreign banks incorporated in the country in which the U.S. multinational does business.

The Administration's proposal implies that the per country rules will bring pressure to bear on foreign jurisdictions to either lower their statutory tax rates or to enter into treaty negotiations with the U.S. We submit that as long as the U.S. source rules are applied to income earned overseas, a U.S. taxpayer's effective tax rate in a foreign jurisdiction may be significantly higher than the jurisdiction's statutory rate. This is the result of income being sourced to one country under the per country limitation while being subject to tax in another country.

Aside from the issue of how the per country limitation would affect U.S. business, many commentators have expressed serious concerns about the extraordinary complexity and administrative requirements built into the per country limitation. The scope of the administrative problems may be demonstrated by Citicorp's international operations. It is physically located in 92 countries but also does business with residents of countries in which it has no office. Citicorp has over 800 controlled foreign subsidiaries, and over 300 foreign affiliates. If the per country limitation is enacted, Citicorp would have to:

° identify and trace relevant income to its country of origin presumably employing U.S source rules even though foreign source rules will often be different;

° allocate appropriate expenses at each corporate subsidiary tier to determine the net income (by U.S. standards) on which foreign tax is imposed by each separate foreign jurisdiction, including allocations of interest expense, head office charges, bad debt deductions and the like; and

° identify taxes associated with the income, which can be further complicated by the fact that several jurisdictions may impose a tax on what is essentially the same pool of income.

These calculations would have to be done by every branch, subsidiary, and affiliate for each country in which Citicorp derives income and pays taxes.

Due to the extraordinary complexity of these provisions it is submitted that it will be many years before the Internal Revenue Service has the capacity to audit the tax returns of businesses that would be subject to the per country limitation. In view of the fact that thousands of U.S. companies, and their foreign branches, subsidiaries and affiliates would be subject to these rules, the audit burdens of the Internal Revenue Service would be greatly magnified beyond its resources.

STATEMENT OF CHARLES W. RAU, PRESIDENT, TAX EXECUTIVES INSTITUTE, INC., OF ARLINGTON, VA, ACCOMPANIED BY MICHAEL J. HENRY, MORTON THIOKOL, INC., CHAIRMAN, INTERNATIONAL TAX COMMITTEE, TAX EXECUTIVES INSTITUTE; AND TIMOTHY J. McCORMALLY, TAX COUNSEL, TAX EXECUTIVES INSTITUTE

Mr. RAU. Mr. Chairman and members of the committee, I am director of taxes for Allis-Chalmers Corp., of Milwaukee, WI, and appear today as president of Tax Executives Institute. The Institute's 4,000 members manage the tax affairs of more than 2,000 of the largest corporations in the United States and Canada, many of which have substantial international operations and investments abroad. I am accompanied today by Michael J. Henry of Morton Thiokol, Inc., chairman of the Institute's International Tax Committee, and by Timothy J. McCormally, the institute's tax counsel.

Tax Executives Institute opposes the administration's proposed adoption of a percountry foreign tax credit limitation as bad tax policy and the inception of an administrative nightmare. While the stated goals of the President's tax proposals are ennobling and worthy of support, the per-country limitation is unfair; it is certainly not simple; and it would inhibit rather than encourage economic growth. The proposal evidences a misconception of the reasons why and how U.S. corporations conduct business abroad. They do so based on economic opportunity and competitive pressures, not for the purpose of avoiding U.S. tax. To assume investments are made in foreign plants and equipment because of a transitory difference between local and U.S. tax rates—or because of a current excess or a capacity to utilize additional foreign tax credits—is simply wrong.

Furthermore, although the Administration's proposal envisions a world where the business activities of multinational companies are planned and conducted on a country-by-country basis, in reality companies address, as the previous speaker indicated, business on a worldwide, or at least on a regional, market basis. The per-country proposal would clearly place U.S. companies at a disadvantage, vis-a-vis non-U.S. companies, at a time when they are already burdened with high real interest costs and a premium-valued U.S. dollar. In effect, U.S. companies would be required to play the game with a two headed coin, and indeed to choose tails. In high tax rate countries, they would pay the local high tax rate; and in low tax rate countries, they would be forced to pay the higher U.S. tax on repatriation of earnings.

The complexities and administrative burdens inherent in the administration's proposals cannot be overstated. They include, No. 1, identification and tracing of income by specific category, to its country of origin—in many cases, through a network of entities incorporated in many different countries. Second, detailed regulation section 1.861-8-type allocations and apportionments would be required for each country and for each basket of income within each country. Third, proper identification of taxes would be required to be associated with each category of income. Fourth, complicated carry-forward and carry-back rules are proposed; and fifth, complex loss allocation and resourcing rules are also suggested. These complicated provisions would be extremely costly for companies doing business abroad, perhaps leading many smaller companies to curtail overseas operations. They would require substantial documentation, create added uncertainty, and virtually guarantee increased tax litigation. The IRS administrative burden would be similarly increased.

The proposal to treat income from the sale abroad of property manufactured in the United States as 100 percent U.S. source income, unless its sales is attributable to a fixed place of business in the country of sale, should also be rejected. It fails to recognize the true economic source of a major component of export income—the place where the manufactured property would be located and from which the sales proceeds emanate.

The committee recently approved a temporary extension of the moratorium on the allocation of research and experimental expenditures under the section 1.861-8 regulations. We would urge this moratorium be made permanent. As the Treasury itself has recognized, the expiration of the moratorium would result in R&D being shifted abroad and an absolute reduction in the overall level of R&D by U.S. companies.

TEI does believe there is a need for genuine balanced reform of the tax credit rules. As indicated more fully in our written statement, which we ask be included in the record, we believe the carry-back and carry-forward periods for foreign tax credits should be made the same as they are for the general business tax credit—3 years back and 15 years forward. We believe that any carry-forward credit should, again as in the case of the general business credit, be taken into account before the current year's credit. We also believe that to further limit the amount of double taxation, foreign and domestic source losses should be treated consistently for recapture purposes, and that the interrelationship of regulations section 1.861-8 and section 904(f) of the code should be addressed legislatively to prevent the same foreign source loss from being used to deny credits in more than 1 year. That concludes my statement.

The CHAIRMAN. Thank you, sir. Mr. Riordan.

[The prepared written statement of Mr. Rau follows:]

STATEMENT

OF

TAX EXECUTIVES INSTITUTE, INC.

ON

THE PRESIDENT'S TAX PROPOSALS AFFECTING THE FOREIGN TAX CREDIT AND THE SOURCING OF INCOME

July 29, 1985

I. BACKGROUND

The United States was the first country to provide a credit on a worldwide basis against the federal income tax for the amount of income taxes paid to foreign countries or U.S. possessions, the Internal Revenue Code having contained a foreign tax credit since 1918. The purpose of the credit is simple: to prevent the double taxation of income earned by U.S. persons. The credit is necessary because U.S. persons are subject to federal income tax on their worldwide income regardless of where it is earned. Since practically all foreign countries also tax income that is in some way effectively connected with their jurisdiction, a U.S. person doing business overseas (directly or through a foreign subsidiary) would -- absent the credit -- be subject to tax twice on the same income.

Almost from the beginning, however, a taxpayer's ability to claim the foreign tax credit has been limited. The purpose of the limitation is also simple: to prevent the credit for foreign taxes paid on foreign source income from offsetting a taxpayer's U.S. tax liability on domestic source income. The operation of the foreign tax credit limitation has a varied past -- the credit has been subject to an "overall" limitation, to a "per country" limitation, or to both on either a mandatory or an elective basis. Except for the period 1954-1960, an overall limitation was either permitted or prescribed, and since 1976 it has been the only limitation. Under the overall limitation, the foreign tax credit is limited to the taxpayer's total U.S tax (before credit) multiplied by a fraction, the numerator of which is all foreign taxable income and the denominator of which is worldwide taxable income. In calculating the overall limitation the taxpayer aggregates all its income, losses, deductions, and credits from foreign sources; that is to say, the taxpayer averages the taxes paid in high-tax countries with those in low-tax countries.

The purpose of the credit and the operation of the overall limitation were summarized by Secretary of the Treasury William Simon in 1976, as follows:

> The foreign tax credit is neither a tax loophole nor an incentive to invest abroad. It is merely part of a system of allocating primary taxing jurisdiction to the country within whose borders the income is earned. U.S. companies are taxable on their worldwide income. Our tax credit system does not reduce the total tax bill of U.S. companies below the amount they would have paid if the income had been earned here. The effect is that the total tax is limited to the higher of the U.S. tax or the foreign tax.

Statement of Hon. William E. Simon Before the Senate Comm. on Finance, 94th Cong., 2d Sess. 96 (Mar. 17, 1976) (testimony on proposal to make overall limitation mandatory).

In chapter 15 ("Reform International Taxation") of The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity (May 1985) (hereinafter referred to as "the President's Tax Proposal," "the Administration's Proposal," or "the Administration's Report"), the President proposes to abandon the overall limitation and to revert exclusively to a per country limitation under which the foreign tax credit limitation would be separately computed for each foreign country and would equal the ratio of taxable income from that country to worldwide taxable income. In arguing for the imposition of a per country limitation, the Administration claims that the overall limitation in current law "favors foreign over U.S. investment"; acts as a "strong incentive to engage in offshore tax haven activity"; and "causes economic decisions to be distorted purely for tax advantage." (President's Tax Proposal, pages 383, 387.) Specifically, the Administration's Report states (at pages 387-88):

> The averaging of effective rates permitted under current law is undesirable for at least two reasons. First, the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries. * * * The overall limitation under current law thus causes economic decisions to be distorted purely for tax advantage. * * *
>
> A second problem is that the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investments. * * * The overall limitation inappropriately requires the U.S. Treasury to bear the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income.

II. SUMMARY OF TEI'S POSITION

Tax Executives Institute opposes as bad tax policy and even worse tax administration the adoption of a per country limitation, and we strongly recommend that the proposal not be included in any tax restructuring legislation enacted by Congress. TEI recognizes that true tax reform will not come without cost or without some complexity, for we live and conduct business in a complicated world economy. We sincerely believe, however, that more must be done than simply espousing the litany of "fairness, growth, and simplicity." The stated goals of the President's Tax Proposal are ennobling and worthy of widespread support, but we respectfully suggest that the Administration's specific proposals in the international area owe more to the revenue they would generate than to the drafters' adherence to the principles of equity, simplicity, and economic neutrality.

We suggest, moreover, that there is little to be gained by facilely invoking the shibboleths "reform" and "neutrality" and the chimeras "abuse" and "economic distortion" as a means of limiting debate and critical analysis. This is especially the case since the President's per country limitation proposal belies the very title given to the Administration's Report: it is not fair; it is certainly not simple; and, perhaps most ironic of all, it would inhibit, rather than encourage, economic growth. The per country limitation proposal should be rejected outright.

Stated simply, the President's Tax Proposal is built on an unsupported foundation. The Administration asserts, for example, that the overall limitation has prompted taxpayers to invest abroad rather than in the United States, but there is precious little evidence (empirical, anecdotal, or otherwise) to support that claim. The Administration also hyperbolically assumes that investment decisions are motivated principally by tax considerations. Our collective experience teaches us, however, that investment decisions -- especially those concerning operating assets --are based on economic opportunity and competitive pressures. Perhaps most important, although the Administration's Report paints a world where the business activities of multinational companies are planned and conducted on an insular, country-by-country basis, companies in reality must deal with a world market (or, at a minimum, a series of regional markets) and establish integrated networks of subsidiaries in many countries to effectively compete.

Because of its weak underpinnings, the arguments for the President's per country limitation proposal prove entirely too much. The proposal would place U.S. companies at a disadvantage in relation to their foreign competitors and thus would violate principles of economic neutrality. By disregarding the fact that companies operate on a worldwide or regional basis rather than a country-by-country basis, it would itself distort economic decision-making and would increase the cost of conducting foreign operations. It would also impose enormously complicated and costly recordkeeping and compliance burdens on taxpayers. In making the proposal, the President throws simplicity to the wind and incongruently ignores the effect of tax policy on international trade and our ability to compete effectively abroad.

Each of these points is developed in more detail below. In addition, we recommend both a substantial modification of the President's proposal for the sourcing of manufacturing income and the permanent extension of the moratorium on the Treasury Department's research and experimental expenditure allocation rules under section 861 of the Internal Revenue Code. Finally, we discuss our previously submitted recommendations that (1) the carryback and carryforward period for foreign tax credit purposes be conformed to the period used for net operating loss and general business tax credit purposes (five years back and fifteen forward), (2) the ordering rules for foreign tax credit purposes similarly be revised to parallel those for general business tax credit purposes, and (3) a domestic loss recapture rule be established. These changes, we submit, would effect real and equitable reform in the foreign tax credit area and would thereby enhance the competitive position of U.S. companies. Indeed, the adoption of the carryback/carryforward and the domestic loss recapture proposals would do much to temper the perception that the Administration's definitions of "reform" and "fairness" as those terms relate to business taxation are almost wholly one-sided -- the side that raises revenue.

III. THE PRESIDENT'S PER COUNTRY LIMITATION PROPOSAL

A. The Proposal Misapprehends the Reasons for Investment Abroad and the Nature of the World Market

In arguing for a per country foreign tax credit limitation, the Administration contends that the overall limitation of current law leads U.S. multinational corporations to invest abroad rather than in the United States and, thus, to distort their worldwide investment decisions "purely for tax advantage." (President's Tax Proposal, pages 383-84, 387.) The Administration, however, cites no data in its report to support its claim of the predominance of tax considerations. This is not surprising for the Administration's claim is simply not true. The decision to locate a plant or other operation in one country or another is never determined solely --or even primarily -- by tax considerations. Business investments turn on myriad factors -- only one of which is the tax consequences flowing from the investment. Among the non-tax factors that companies take into account are (1) proximity to markets, (2) relative manufacturing and distribution costs, (3) transportation costs, (4) customs duties, (5) the extent of the company's existing U.S. manufacturing operations and the cost of establishing similar operations abroad, (6) domestic content requirements imposed by the jurisdiction of a targeted foreign market, (7) balance of trade pressures imposed by the foreign market, (8) exchange controls, and (9) the political stability of a foreign jurisdiction. These and similar factors almost without question take precedence over tax considerations.

The very fact that numerous U.S. companies now face foreign tax credit carryforwards and that most foreign investments by U.S. companies are in countries with high tax rates provides evidence of the true driving forces in making non-U.S. investments. Competitive pressures, import restrictions, and economic opportunity direct these investments. Were tax considerations to obtain the status ascribed to them in the President's Tax Proposal, U.S. investments in countries such as Canada (with a 51 percent tax rate), the United Kingdom (until recently, with a 52 percent tax rate), France (with a 50 percent tax rate), Germany (with a 56 percent tax rate) and Australia (with a 46 percent tax rate) would be non-existent.

The Administration would apparently argue that, to the extent companies invest in such high-tax countries, it is because the U.S. Treasury "bears the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income." (President's Tax Proposal, page 388.) That is to say, the Administration attempts to have it both ways. First, it argues that the overall limitation is bad because it prompts companies in high-tax countries to invest in low-tax countries; then, it reverses itself and argues that it is bad because it provides an incentive to companies in low-tax countries to invest in high-tax jurisdictions! Such Janus-faced nimbleness may be justifiable in an academic setting, but in the legislative realm it is not: it ignores the real world. It also ignores the fact that job performance by operating managers -- those persons responsible for investment decisions -- is generally measured on a pre-tax rather than a post-tax basis.

Moreover, to the extent tax considerations are taken into account, the lowering of the U.S. corporate tax rate (from 46 percent to 33 percent) will operate to mitigate any perceived bias against investing in the United States that the President believes the overall limitation might exacerbate. In other words, the lower U.S. rate will lead to more -- not less -- domestic investment and will allay concern that capital will be directed offshore in an effort to absorb excess foreign tax credits.

Perhaps more troubling than the Administration's misapprehension of the reasons for investing abroad is its failure to fully appreciate the transnational nature of the operations of most multinational corporations. Companies do not organize on a country by country basis (even if separate companies or subsidiaries are established in each of several nations). Rather, they establish integrated networks of companies that span an entire region or perhaps most of the markets in the world outside the United States. In light of the world market in which U.S. companies compete, it makes little sense to apply a per country limitation.

In contrast, the overall limitation is better suited to the worldwide or regional markets in which companies and countries compete since it provides for the aggregation of all foreign taxes and foreign income in determining the allowable foreign tax credit. It was this fact that led a Task Force of the House Ways and Means Committee in 1977 to conclude that the averaging of foreign taxes allowed under the overall limitation was in many instances quite "appropriate." The Task Force, which was chaired by Congressman Dan Rostenkowski, explained:

> Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.

House Comm. on Ways and Means, Recommendations of the Task Force on Foreign Source Income, 95th Cong., 1st Sess. 35 (Mar. 1977). See also E. Owens, The Foreign Tax Credit 313 (1961) ("The overall limitation is clearly preferable in terms of administrative simplicity; it provides a greater degree of internal consistency in the tax credit system; and it probably conforms more closely with the attitude of taxpayers towards the basic problem presented by the simultaneous imposition of foreign and United States taxes.").

In this regard, a reference must be made to the statement in the President's Tax Proposal (at page 395) that "consideration" will be given to allowing the foreign tax credit limitation to be calculated on a regional or integrated operation basis. To our mind's eye, that statement --and other assurances that simplified, more administrable, more realistic alternatives will be "considered" (see, for example, President's Tax Proposal, pages 392, 393, and 395) -- represent more an attempt to diffuse or sidestep valid criticisms by mouthing hollow promises than sincere recognition of the necessity -- as a matter of sound trade and economic policy -- of viewing the world market as it really is. This is especially the case in light of the Administration's insistence that any alternative has to be "consistent with the underlying rationale of the per country limitation" (President's Tax Proposal, page 395) -- even though it is that rationale that is at odds with the reality of the marketplace and that necessitates "consideration" of such alternatives in the first instance.

B. The Proposal Threatens to Adversely Affect the Ability of U.S. Companies to Compete Effectively Abroad

Tax Executives Institute believes that the imposition of a per country limitation would detrimentally affect the ability of the United States to compete in world markets by effectively increasing the costs of doing business abroad. Thus, the President's Tax Proposal is at odds not only with the goals of equity and economic neutrality, but also with the legislative intent underlying the enactment just last year of the foreign sales corporation provisions of the Internal Revenue Code. U.S companies should be encouraged to expand their overseas activities. The Administration's proposal, however, points in the opposite direction -- it would operate as a not too subtle disincentive. Even in the short term, adoption of a per country limitation would be short sighted, since foreign investment and operations by U.S. businesses provide significant benefits to the U.S. economy in terms of increased exports (which would lead to a healthier balance of trade) and the generation of additional tax revenue.

As a practical matter, of course, taxpayers involved in the world economy have no choice but to penetrate -- or attempt to penetrate -- foreign markets. At a time when the President's Commission on Industrial Competitiveness has called on the Administration to adopt domestic and export policies that "encourage U.S. trade and industry adjustment to global competition," it would seem inappropriate for the President to propose new barriers to the ability of United States companies to compete internationally. The per country limitation, however, would operate as such a barrier -- indeed, as a two-headed coin (with the U.S. taxpayer being compelled to choose tails). In high tax rate countries a company would pay the higher foreign tax rate and in low tax rate countries it would pay the higher U.S. tax rate -- even though, in the aggregate, the foreign tax rate is higher than the U.S. tax rate. This result will be especially harsh with respect to existing foreign investments.

Moreover, to the extent taxes play a role in investment decisions (and we reiterate that they do not in our view play a major role), the imposition of a per country limitation could potentially distort economic decision-making by encouraging business operations to be located in low tax rate countries, thereby forgoing opportunities in high tax rate countries. In other words, assuming arguendo the Administration's claim that tax considerations predominate, the proposal could produce the very result it is intended to forestall.

The adverse effects of the per country limitation would be especially pronounced where foreign subsidiaries operating in several countries are incorporated in countries that (like the United States) tax them on worldwide income and would be exacerbated by the Administration's proposed sourcing rules. The President's Tax Proposal is intended "to associate income more appropriately with the source of the underlying economic activity" (President's Tax Proposal, page 384), and would for credit purposes attribute taxes imposed by the country of incorporation only to gross income from sources within that country. For example, with respect to the indirect credit, the Administration's Report states that "foreign taxes would be matched as closely as possible with the foreign income to which they relate." (President's Tax Proposal, page 391.) Consequently, to the extent the country of incorporation imposes taxes on income not sourced to that country under the Administration's proposed "underlying economic activity" test, the President's Tax Proposal would increase the cost of doing business abroad. The Administration acknowledges this, but states that the harsh results of "temporal mismatching of income and conflicting source rules" (President's Tax Proposal, page 389) can be minimized by extending the credit carryforward period from 5 to 10 years and by affording taxpayers an option (on a country-by-country basis) to deduct foreign taxes paid (regardless of where they are sourced) in lieu of claiming a credit for such taxes (subject to the per country limitation and the new sourcing rules). We suggest, however, that the relief offered by these proposed changes would be scant and, indeed, that they represent an implicit admission of the per country limitation's operational shortcomings.

Finally, the President's Tax Proposal would not only increase the cost of doing business abroad, but it would also discourage the repatriation of funds from foreign subsidiaries, thereby aggravating the U.S. balance of payments situation. In this respect, too, the imposition of a per country limitation would make tax considerations a more -- not less -- important factor in business decisions. For example, companies might feel compelled for tax purposes alone to expand their networks of foreign subsidiaries (thereby increasing administrative complexities) in order to mitigate the harsh effects of the Administration's proposed attribution of taxes imposed by the country of incorporation only to gross income from sources within that country.

C. The Proposal Would Impose Horrendous Administrative and Compliance Burdens on Taxpayers as well as the Internal Revenue Service

Even if the per country limitation were consistent with the stated goals of the President's Tax Proposal and even if it did not substantially increase the costs of doing business overseas (thereby impairing our ability to compete), Tax Executives Institute would oppose it because of the horrendous administrative burdens and complexities it would impose.

The overall limitation is already plagued by complexities involving allocations under section 1.861-8 of the income tax regulations, the sourcing and re-sourcing of income (especially after the Tax Reform Act of 1984), and pricing adjustments under section 482. Those complexities, however, would pale by comparison with the added burdens the imposition of the Administration's per country limitation would engender. For example, the President's Tax Proposal would require a separate computation for each country from which a taxpayer directly or indirectly derives revenue. Each of these computations would require the taxpayer to calculate the gross income and deductions to be allocated to each country. This complicated process could easily lead to arbitrary results, especially if U.S. sourcing income rules were applied to wholly foreign transactions (as the Administration proposes).

In 1975, the Staff of the Joint Committee on Internal Revenue Taxation addressed the relative administrative burdens that the overall limitation and per country limitation impose on taxpayers and the Internal Revenue Service and found the per country limitation quite wanting:

> The separate computation must be made for each country in which a taxpayer operates. Each of these computations requires the taxpayer to calculate the gross income and deductions to be allocated to each country. Since, as discussed above, many large companies operate on an

> integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world.

Staff of the Joint Comm. on Internal Revenue Taxation, U.S. Taxation of Foreign Source Income -- Deferral and the Foreign Tax Credit 20 (Sept. 27, 1975); accord E. Owens, The Foreign Tax Credit 313 (1961) ("The overall limitation is clearly preferable in terms of administrative simplicity * * *"). It should be pointed out, moreover, that unlike the strict per country limitation that the Joint Committee was addressing, the Treasury proposal would also require that losses from other countries be allocated to the countries in which there was taxable income.

Notwithstanding the implication to the contrary in the Administration's Report ("international norms for source of income determination should be followed," President's Tax Proposal, page 399), the tracing and reallocation that would be required under the President's proposal would be extremely complex and far more complicated than the rules utilized by our trading partners. Specifically, TEI foresees the following compliance burdens flowing from the President's proposal:

1. Identification and tracing of relevant income by specific category to its country of origin, in many cases through a complicated network of corporations incorporated in many different countries.

2. Regulations section 1.861-8-type allocations and apportionment for each country and for each category of income within each country.

3. Proper identification of the taxes associated with each category of income. In this regard, we note that it is quite possible that one country may tax income that the Internal Revenue Service would trace to a different country. (The President's Tax Proposal itself recognizes this (at page

> 389).) Note also that some countries do not tax certain categories of income, e.g., foreign source dividends, but disallow certain expenses attributable to such income. This represents, in effect, a hidden tax on the income.

4. Extraordinarily complicated carryforward and carryback rules that are difficult to envision even in the abstract.
5. Complex loss allocation and resourcing rules.

The burdens posed by a per country limitation would not fall only on the taxpayer. The Internal Revenue Service, too, would have to contend with Administration's labyrinthian rules on the measurement of earnings and profits, the sourcing of income, the matching of taxes with income, the allocation of expenses and losses, the recapture of losses, and the regeneration of income. The Administration's Report itself states (at page 395):

> It is recognized that these appropriate results will be achieved only through imposition of significant new burdens on both taxpayers and the Internal Revenue Service. Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation. The per country limitation will make determinations regarding the source of subsidiary income, correct intercompany transfer pricing, and expense allocation involving exclusively foreign operations relevant to the foreign tax credit computation. The recordkeeping burdens on taxpayers and auditing burdens on the IRS will be correspondingly increased.

Even after acknowledging these problems, however, the Administration persists in pressing for imposition of a per country limitation. How does it address the administrative problems? The Administration states that it had been unable to devise a more workable approach that was "consistent with the underlying rationale of the per country limitation" and then blithely adds —

> * * * the advantages of the per country limitation are believed to be important enough to warrant the additional complexity and recordkeeping burdens.

As the individuals who would have to deal with that additional complexity and assume those additional recordkeeping burdens, we vigorously disagree. Consequently, we strongly urge Congress to reject the Administration's per country limitation proposal. If specific abuses in the foreign tax credit limitation or in the source of income rules can be identified, TEI would be more than willing to work with Congress and the Treasury Department to address those problems. We believe it is imperative, however, that the response to any abuses or perceived abuses should be focused. Nothing is gained by enacting an ill-conceived and administratively complex set of rules that can only work to the detriment of the United States as a whole in the international marketplace.

IV. THE PRESIDENT'S PROPOSAL ON SOURCING OF MANUFACTURING INCOME

Tax Executives Institute objects to the Administration's proposal to treat income from the sale of property manufactured in the United States as 100 percent U.S. source income unless its sale is attributable to a fixed place of business abroad. (President's Tax Proposal, pages 402-03.) The President's Tax Proposal would generally attribute an arbitrary (but unstated) percentage of manufacturing income to the place of manufacture and the remainder to the fixed place of business outside the United States that "participates materially in the sale" and would source to the United States all income from the sale of manufactured property to a foreign subsidiary or affiliate. (President's Tax Proposal, pages 402-03.) The Administration argues that the proposed rule would be less subject to manipulation and more reflective of real underlying economic activities than the existing rule (under which one-half the income is allocated to the place of manufacture and the other half is allocated to the place where title passes). (President's Tax Proposal, pages 399, 402-03.)

In our view, the President's proposal fails to recognize the true economic source of export income -- the place where the manufactured property will be located and the sales proceeds originate. Concededly, some portion of the income should be sourced to the place of manufacture (as it is under current law), but without a sale to a customer (foreign or otherwise), the manufacture of the property will generate no income. The location of the customer -- the destination of the manufactured property, therefore, is critical. This is the case, moreover, regardless of whether the property is sold directly to a foreign customer or whether it is sold to a foreign sales or affiliate which resells it in a foreign market immediately or after further manufacturing takes place.

In addition to making little economic sense, the President's proposal would remove a substantial incentive for exporters by significantly increasing the relative U.S. tax burden on exported products and thus could exacerbate the continuing substantial U.S. trade imbalance. Raising the relative effective tax rate on U.S. exports at a time when these are seriously disadvantaged by the strong dollar, high financing costs, and intense foreign competition could only be counterproductive. It also seems inconsistent with the policies underlying the enactment in 1984 of the foreign sales corporation provisions of the Internal Revenue Code.

Equally significant, the Administration's proposal would inject a new, untested concept into the process. What is a "fixed place of business"? How will it be determined -- in accordance with U.S law, local law, or relevant tax treaties? Until these questions are resolved, taxpayers would not be able to plan effectively.

TEI appreciates the President's concern that source of income rules should not be subject to taxpayer manipulation as may be currently possible under the passage-of-title test. We believe, however, that the rules displacing that test should be clear and easily administrable. The President's proposal promises to be neither. Thus, although the Administration's Report states that a fixed percentage allocation will be "considered" (President's Tax Proposal, page 403), the inference to be drawn is that the "arbitrary percentage" of income sourced to the place of manufacture -- as determined by the Treasury Department -- will be arbitrary indeed: 100 percent.

We submit that the legitimate goals of the President's Tax Proposal can be accomplished, without the negative effects of the proposed sourcing rules -- specifically, by adoption of a realistic and administrable rule that sources income derived from the manufacture and sale of property equally between the place of manufacture and the destination of the sale.

V. THE PRESIDENT'S PROPOSAL ON ALLOCATION OF INTEREST EXPENSE

Tax Executives Institute submits that the President's proposal to allocate interest expense to income from various sources on a combined group basis could harshly and inequitably affect taxpayers who have relied on the current separate company rule. (President's Tax Proposal, page 404.) Thus, at a minimum, we recommend that the deduction for interest expense continue to be allocated on the separate company basis with respect to old debt. A U.S. multinational that has borrowed to modernize its plant and equipment in the United States should not now have its effective cost of capital increased retroactively by, in effect, disallowing a portion of the deduction for interest expense. Any change in these rules should apply only with respect to new debt. Taxpayers who incurred debt in reliance on current law should not be penalized by retroactive application of new rules. We note in this regard that the Administration's Report provides that the allocation proposal would be applied only prospectively with respect to 80-20 companies. (President's Tax Proposal, page 404.) We see no reason, however, why such relief from the retroactive application of adverse changes -- usually a mainstay of tax legislation -- should not be extended to all taxpayers.

VI. THE ALLOCATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Tax Executives Institute is disappointed that the President's Tax Proposal does not include the proposed extension beyond 1985 of the current moratorium on the allocation of research and experimental expenditures (as defined in section 174 of the Code) under section 1.861-8 of the Treasury Department's income tax regulations. We submit that all expenses qualifying under section 174 that are attributable to research activities conducted in the United States should be allocated to sources within the United States. The failure to make permanent the current moratorium on the allocation of such expenses to foreign sources would constitute a significant blow to research efforts in the United States.

First in 1981 and then again in 1983, Congress intervened to prevent the Treasury Department from applying its regulations under section 861. Before the eneactment of the moratorium (which is currently scheduled to expire at the end of 1985), when a taxpayer performed research activities in the United States, a portion of the tax deduction for expenses attributable to that research would be allocated to the taxpayer's foreign source income. In certain cases this allocation would have the effect of denying the taxpayer a foreign tax credit on that income, thereby effectively depriving the taxpayer of the benefit of that portion of the deduction in the United States and subjecting the taxpayer to double taxation.

The allocation rules under section 1.861-8 of the regulations represent a clear disincentive to the performance of research and experimental activities in the United States as opposed to European and other countries. The effect of allowing the moratorium to expire, therefore, would be to undermine the policy underlying

Congress's -- and the Administration's -- decisions (evidenced by the enactment and proposed extension of the research tax credit) to favor research conducted in the United States.

In a June 1983 report on the effect of the section 1.861-8 regulations, the Treasury Department itself acknowledged that the expiration of the moratorium would have a dual adverse effect: not only would the Treasury's regulations cause some research to be conducted abroad rather than in the United States, but they would reduce the overall level of research activities. According to the Treasury's estimates, in 1982 domestic research spending would have been between $40 million and $260 million less if the section 1.861-8 regulations had been in effect. We believe those estimates understate the negative effect of the regulations.

In summary, we believe that the congressional mandated policy of encouraging research in the United States would be detrimentally affected by the expiration of the moratorium, and we urge the moratorium to be made permanent.

VII. TEI'S RECOMMENDATIONS FOR REAL FOREIGN TAX CREDIT REFORM

In addition to the foregoing comments on the President's specific proposals regarding the foreign tax credit and the sourcing of income, Tax Executives Institute recommends that the following proposals concerning the foreign tax credit carryforward and carryback rules and the foreign loss recapture provisions of the Code be incorporated into any tax restructuring legislation enacted by Congress. We submit that adoption of our recommendations -- which we and other taxpayer groups have long advocated -- will result in the true and equitable reform of the foreign tax credit provisions of the Code.

Furthermore, we believe these changes are needed to restore some measure of balance to the Administration's international tax reform proposals and to dispel the notion that those proposals are one-sided. If equity and fairness are truly the principles underlying the tax reform movement, then these changes (even though by themselves they might reduce revenues) are without a doubt needed. Indeed, we respectfully submit that the revenue estimates associated with the proposals (which Treasury officials have cited as the primary reason for the Administration's opposition to these proposals) attest to their urgent need -- they in effect document the current level of double taxation.

A. Carryback and Carryforward Rules

1. Description of the Problem. Currently, any foreign tax credits not used against U.S. tax in the current year may be carried back only two years and forward only five (section 904(c)). These rules pale in comparison to the analogous rules in respect of the general business tax credit (new section 39) and net operating losses (section 172(b)); those rules provide for a three-year carryback and a fifteen-year carryforward. There is no readily explainable reason for the harsher rules in the foreign tax credit area. In fact, when each was originally enacted as part of the 1954 Code, the carryforward/carryback provisions in respect of net operating losses and the foreign tax credit were identical -- two years back and five years forward. Although the rules have been liberalized several times for net operating losses (and investment tax credits) since 1954 (most recently in 1981 as part of the Economic Recovery Tax Act), the foreign tax credit provisions have, for no apparent reason, been substantially ignored.

In addition, the ordering rules contained in section 904(c) for foreign tax credits require that the current year's credits be utilized before any carryovers are taken into account. By contrast, in respect of the general business tax credit, a carryover is to be used first, before the current year's credits, to afford the taxpayer the maximum opportunity of using the credit (new section 38(a)).

This lack of consistency and equity in the Code penalizes taxpayers who experience operating losses and, indeed, frequently allows the government to reap a windfall at the expense of distressed taxpayers. Consider, for example, a situation where a company incurs large domestic net operating losses in both 1984 and 1985. These losses will be carried back to 1981, 1982, and 1983, respectively, possibly reducing taxable income in each of those years to zero. Because of the loss carrybacks to 1981, 1982, and 1983, the foreign tax credit attributable to taxes paid on foreign source income in those three years may be carried back two years and forward five. If there is no foreign tax credit limitation available in years prior to 1981, the only alternative is to carry the credits forward to 1986. This means that 1986 will be the only year available to absorb the 1981 credits and then only if there is some part of the limitation available after absorbing any 1986 credits. Thus, in this example the 1981 credit carryover, triggered by a 1984 loss on domestic operations, must be absorbed in 1986 or double taxation of the 1981 foreign income will result.

What very often occurs under current rules, then, is that the government collects (or disallows) a substantial portion (if not all) of the foreign tax credits previously earned and claimed because of the short carryback/carryforward period. Indeed, the lack of consistency in the foreign tax credit area effectively undermines the intent behind both the foreign tax credit and the NOL carryback/carryforward rules, for the net operating loss relief is reduced by the previously allowed foreign tax credits. The current foreign tax credit rules, therefore, place an even larger burden on a distressed company trying to recover from a loss position.

The present carryback/carryover rules also adversely affect the cash flow from foreign subsidiaries and, thus, are not economically neutral. Specifically, a company's inability to utilize the foreign tax credits associated with dividends that would otherwise have been repatriated from foreign subsidiaries, in combination with the doubtful outlook for ultimate realization of the credits within the carryback/carryover period, leads the company to cancel dividends planned from these companies; in such situations, it simply cannot risk having the carryover period expire before the credit can be utilized. Such a result is especially troublesome where the company has short-term borrowings outstanding against which the cash dividends can be applied. In such a case, the cash generated by foreign subsidiaries remains abroad to the benefit of the credit and jobs markets outside of the United States while the parent company is compelled to borrow additional funds in this country.

In addition, the failure to repatriate earnings from foreign subsidiaries impairs our country's balance of payments and encourages expansion overseas rather than in the United States. Thus, the present rules seem ill advised not only as a matter of tax equity but also from an economic policy standpoint.

2. Proposal for Reform. Tax Executives Institute recommends that corrective action be taken to end these inconsistent and inequitable results. Specifically, section 904 of the Internal Revenue Code should be amended to provide a foreign tax credit carryback/carryover period that is identical with that allowed for net operating losses and general business tax credits (i.e., three years back and fifteen years forward). Second, the ordering rules for foreign tax credit purposes should parallel those for the general business credit: any carryover credit should be taken into account before the current year's credit.

In this regard, it should be noted that the Administration itself proposes that the carryforward period be extended from 5 to 10 years. (President's Tax Proposal, page 390.) Although the Administration would limit the extended period to credits generated after the enactment of its per country limitation proposal, we submit that the two proposals should not be tied together. Rather, as already stated above, we believe that the per country limitation proposal should be rejected and the carryback and carryforward periods should be lengthened.

B. Foreign Loss Recapture Rules

1. Description of the Problem. The recapture rules of section 904(f) are deficient in several respects. Perhaps most significant, they lack symmetry in situations where foreign source income is offset by a domestic source loss. This could result in an unintended (or, in any event, inequitable) permanent loss of foreign tax credits with respect to the foreign taxes paid on the foreign source income, unless in subsequent years an equal amount of domestic source income is reclassified as foreign source income. The unfairness and illogic of such a result is best illustrated by the examples attached as Schedule A (and elaborated on in Schedule B). Example I in Schedule A illustrates the effect of section 904(f) in requiring the recharacterization of foreign income as domestic income to the extent of the prior overall foreign loss. Section 904(f), of course, provides for recapture of overall foreign losses and does not provide for similar recapture treatment when there is an overall domestic loss which is offset against foreign income in year one and in a subsequent year or years there is sufficient domestic income to otherwise absorb such overall domestic loss. Consequently, the credit can be lost where a taxpayer has an overall domestic loss and positive foreign income.

This unjustified result is illustrated by Example II in Schedule A. In year one the domestic loss offsets the foreign income and there is no net U.S. income tax liability. The excess foreign tax credit of $46,000 in year one is available as a carryback or carryforward under section 904(c). In year two foreign income is at the same level as in year one ($100,000) and foreign tax paid or accrued totals $46,000. Domestic income is $100,000 and the total U.S. taxable income equals $200,000. This results in a U.S. income tax liability of $92,000. With no recapture provisions for the prior year's overall domestic loss, the section 904 limitation is equal to the ratio of foreign source income ($100,000) to total U.S. taxable income in year two ($200,000) multiplied by U.S. income tax before credit ($92,000), or $46,000. As a result, the taxpayer's net U.S. income tax liability in year two is $46,000. Since there is no net domestic income for the two-year period (therefore, no net U.S. tax should have been incurred), the pre-credit U.S. income tax ($92,000) for the two-year total foreign income ($200,000) should have been totally offset by $92,000 of foreign tax credit.

2. Proposal for Reform. As explained above, section 904(f) frequently aggravates the very hardship that the foreign tax credit was intended to prevent -- double taxation. This, in turn, discourages companies from making investments that could benefit the U.S. economy as a whole. Tax Executives Institute believes that the inequities caused by the foreign tax credit limitation can best be ameliorated by extending the overall loss provisions to apply equally to domestic loss situations to the extent the overall domestic loss offsets foreign source income in any year. In other words, the domestic loss recapture rule should become the mirror image of the foreign loss recapture rule. The effect of such a change is illustrated by Example III in Schedule A. In year two to the extent that the overall domestic loss from year one would otherwise have been absorbed against domestic

income, such recapture of domestic loss should be reclassified as foreign source income consistent with the similar treatment afforded the recapture of foreign losses under section 904(f).

In addition, there is a conflict between section 904(f) and section 1.861-8(e)(8) of the regulations that will lead to a double loss of foreign tax credits in situations where a taxpayer has a foreign source loss and an overall net operating loss. In such a case, when the net operating loss is carried back, the foreign portion of that loss will offset the foreign source income in the carryback year resulting in loss of tax credits in the carryback year. At the same time, section 904(f) requires that the same overall foreign loss that was carried back under section 1.861-8 be recaptured against future foreign source income, again resulting in losses of foreign tax credits. This is hardly consistent with the purpose of the foreign tax credit -- to avoid double taxation. To effect that purpose, section 904(f) should be modified so that the amount to be recaptured is reduced by the amount offset against foreign source income in the carryback year.

Under section 904(f)(1), the amount of overall foreign losses must be recaptured by reclassifying subsequent years' foreign source income as domestic source income. This reclassification effectively denies taxpayers the intended benefit of foreign tax credits. Under section 904(f)(1)(B), the amount of income subject to reclassification in any one year is limited to 50 percent of the foreign source income for that year before reclassification. This rule makes it extraordinarily difficult for a taxpayer in an overall foreign source loss position to use its foreign tax credits since current year's foreign source income is always first recaptured under section 904(f) thereby reducing the amount of limitation available for current years. If the overall foreign loss subject to recapture is sufficiently large (because, for example, of a foreign worthless stock or bad debt deduction), the taxpayer might be unable to utilize foreign tax credits for a number of future years.

Tax Executives Institute believes the time frame for recapturing overall foreign losses is unduly restrictive. We accordingly propose that overall foreign losses be treated in the same manner as domestic net operating losses, that is, over a fifteen-year period. In addition, to eliminate the harsh effects on the ability to absorb foreign tax credits in the year immediately subsequent to the overall loss year, we propose that the amount of foreign source income to be recaptured in any one year be changed from the present 50 percent of foreign source income before reclassification to 6-2/3 percent. The latter percentage corresponds to a pro rata recapture over the fifteen-year period. As in the current law, the taxpayer should also have a choice of recapturing more than the required amount in any given year.

VIII. CONCLUSION

If you or your staff should need additional information or wish to discuss these comments, please do not hesitate to call Larry R. Langdon, chairman of TEI's International Tax Committee, at (415) 857-3948, or Timothy J. McCormally, TEI's Tax Counsel, at (703) 522-3535.

Respectively submitted,

TAX EXECUTIVES INSTITUTE, INC.

Attachment

FOREIGN TAX CREDIT LIMITATION
SCHEDULE A

	Example I *§904(f)—Foreign Loss Recapture*	*Foreign Tax*	*Example II* *Present Law—Domestic Loss*	*Foreign Tax*	*Example III* *Proposal—Domestic Loss Recapture*	*Foreign Tax*
YEAR 1						
Foreign Source Income	$(100,000)	$ —0—	$ 100,000	$46,000	$ 100,000	$ 46,000
Domestic Source Income	100,000		(100,000)		(100,000)	
U.S. Taxable Income	$ —0—		$ —0—		$ —0—	
U.S. Income Tax	$ —0—		$ —0—		$ —0—	
Allowable Foreign Tax Credit (Schedule B)	$ —0—	$ —0—	$ —0—	$ —0—	$ —0—	$ —0—
Excess Foreign Tax Credit (Year 1)		$ —0—		$46,000		$ 46,000
YEAR 2						
Foreign Source Income	$ 100,000	$46,000	$ 100,000	$46,000	$ 100,000	$ 46,000
Domestic Source Income	100,000		100,000		100,000	
U.S. Taxable Income	$ 200,000		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Allowable Foreign Tax Credit (Schedule B)	$ —0—	$ —0—	$ 46,000	$ 46,000	$ 92,000	$ 92,000
Excess Foreign Tax Credit (Limitation) (Year 2)		$ 46,000		$ —0—		$(46,000)
SUMMARY						
Foreign Source Income						
Year 1	$(100,000)		$ 100,000		$ 100,000	
Year 2	100,000		100,000		100,000	
	$ —0—		$ 200,000		$ 200,000	
U.S. Income Tax	$ 92,000		$ 92,000		$ 92,000	
Foreign Tax Credit	—0—		46,000		$ 92,000	
Net U.S. Income Tax	$ 92,000		$ 46,000		$ —0—	
Excess (Unused) Foreign Tax Credit	$ 46,000		$ 46,000		$ —0—	

SCHEDULE B
FOREIGN TAX CREDIT LIMITATION

	I	II	III
YEAR 1	$\frac{-0-}{-0-} \times -0- = \underline{\underline{-0-}}$	$\frac{100,000}{-0-} \times \underline{\underline{-0- =}}\ -0-$	$\frac{100,000}{-0-} \times -0- = -0-$
YEAR 2	$\frac{100,000 - 100,000}{200,000} \times 92,000 = \underline{\underline{-0-}}$	$\frac{100,000}{200,000} \times 92,000 = \underline{\underline{46,000}}$	$\frac{100,000 + 100,000}{200,000} \times 92,000 = \underline{\underline{92,000}}$

STATEMENT OF JAMES Q. RIORDAN, SENIOR VICE PRESIDENT, MOBIL CORP., NEW YORK, NY, ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL

Mr. RIORDAN. My name is Jim Riordan. I am the senior vice president of finance of Mobil Corp., and I am appearing on behalf of the National Foreign Trade Council, an organization of over 500 U.S. firms engaged in international trade. I would like to address two issues: the proposal to repeal or amend the overall limit on the foreign tax credit, and the proposal to repeal by legislation provisions in the income tax regulations that would require interest expense to be allocated on a company-by-company basis.

I agree completely with what the two earlier speakers have said on the overall credit, and I will be brief on that point. The Treasury proposal would repeal the overall method and substitute a novel, hybrid, per-country method that is not used by any other country, would be incredibly complex to administer, and would make U.S. companies less competitive. We do not know of any U.S. business that supports the Treasury's proposal. I might add at this point that the options recently tabled before the Ways and Means Committee are also novel and complex. Our initial reaction is that they would be even more burdensome and harmful to U.S. companies than the Treasury proposal. The present rules are working reasonably well. We should leave the overall foreign tax credit limitation alone. Now, I would like to turn to the interest allocation issue. The Treasury also asks you to repeal its own interest allocation regulations that have been in place since 1966. The allocation is now done on a separate company basis. The Treasury proposal would ignore separate companies. U.S. business opposes the Treasury proposal. It is not used by any other country. It would make U.S. companies less competitive. I would like to give you two actual examples of what the practical consequences would be if the Treasury proposal were to be adopted.

In 1975, Mobil Alaska, one of our subsidiary companies, borrowed more than $300 million to build its share of the Alaska pipeline. Under the Treasury proposal, part of that borrowing would have to be deemed to have been made by Mobil Oil Indonesia, although Mobil Oil Indonesia didn't need to borrow any money in 1975, and in fact, did not borrow any money in 1975. When it came time to develop a large gas field in northern Samatra, Mobil Oil Indonesia did need to borrow $300 million from an international consortium of banks. It did so on a nonrecourse basis. The development was very successful. The banks were subsequently repaid by Mobil Oil Indonesia out of the income from that project. Mobil Oil Indonesia is now debt-free and is in no need to borrow money. In fact, it remits very significant dividends to Mobil in the United States each year. Nevertheless, under the Treasury's proposal, Mobil Alaska's remaining debt from its 1975 borrowing would be deemed to be in part a liability of Mobil Oil Indonesia in 1986. Now, the Government of Indonesia is not going to allow Mobil Oil Indonesia to deduct any part of the interest expense incurred by Mobil Oil Alaska. Under the Treasury proposal, however, Mobil would not receive a full U.S. tax benefit from Mobil Alaska's interest expense. As a result, we would be exposed to double taxation and the after-tax cost of borrowing to build Mobil Alaska's share of the Alaska pipeline would be higher than those incurred by its competitors, both domestic and foreign. Another example will make even clearer the bizarre practical consequences of the Treasury proposal.

As you know, Mobil Corp. owns Montgomery Ward, a domestic retailer. Montgomery Ward has to borrow a great deal of money in order to carry its inventory and to sell goods on credit to its customers. For financial and policy reasons, Mobil has been very careful to keep Montgomery Ward's debt separate and apart from the debt issued by other Mobil companies. Nevertheless, under the Treasury's proposal, the debt that Montgomery Ward incurs to carry inventory and finance sales to customers in the United States would not be fully deductible because it would be deemed to have been borrowed in part by Mobil Oil Indonesia. Our competitors would not suffer this disadvantage. J.C. Penney wouldn't suffer, and Marshall Field wouldn't suffer. J.C. Penney only operates in the United States, so it doesn't do business abroad. Marshall Field is part of a multinational operation, but its parent company is British, so the rules wouldn't apply to them.

The CHAIRMAN. I will have to ask you to conclude, Mr. Riordan.

Mr. RIORDAN. Thank you. I think that gives you an illustration of what this proposal does.

The CHAIRMAN. And it is a good illustration. Mr. Miller.

[The prepared written statement of Mr. Riordan follows:]

STATEMENT OF NATIONAL FOREIGN TRADE COUNCIL, INC., JAMES Q. RIORDAN, SENIOR VICE PRESIDENT AND DIRECTOR, MOBIL CORP.

My name is James Q. Riordan. I am Senior Vice President for Finance and a Director of Mobil Corporation. I worked for the House Ways and Means Committee as a tax lawyer in 1951 and 1952 and for the Tax Division of the Department of Justice from 1952 until 1954. I was in private practice until 1957 at which time I joined Mobil as a tax lawyer. I have held my present position since 1979.

I appear today before the Committee on behalf of the National Foreign Trade Council, Inc., an organization of over 550 U.S. firms engaged in all important aspects of international trade and investment.

The National Foreign Trade Council supports the objectives of the President's proposals: fairness, growth and simplicity; but the Council feels that the objectives are not achieved by certain of the international proposals; certainly economic growth is not achieved by proposals that would impair the ability of U.S. businesses to successfully compete against their foreign counterparts.

There are a number of changes in the international area proposed to the current law that would be disadvantageous to the U.S. interest. The adoption of those proposals would increase tax costs for U.S. businesses, placing them at a competitive disadvantage in the international marketplace, both here and abroad. A separate statement covers all of these disadvantageous changes. My remarks will focus on the proposals to change the method of computing the foreign tax credit limitation and to change the method of allocating interest expense.

General Comments

The United States taxes the worldwide income of its citizens. This is a broad claim of jurisdiction, and in order to avoid double taxation and maintain the competitive position of U.S. multinationals a foreign tax credit is provided for foreign income taxes paid on foreign source income.

The method for calculating the limitation on the foreign tax credit has changed over the years since it was introduced in the U.S. tax law in 1918, sometimes using only the overall method (1921-1932, 1976-to-date), sometimes only the per-country method (1954-1960), sometimes the method producing the lesser benefit (1932-1954) and sometimes the more advantageous of the two methods (1960-1976). Since 1960 taxpayers have had the right to use the overall limitation method and since 1976 (1975 for oil companies) they have been obliged to use that method.

Congress has also established special rules regarding the taxation of foreign oil extraction income in 1969, 1975, 1976 and 1982. The foreign tax provisions have not suffered from lack of attention over the years. Understandably Treasury, the Internal Revenue Service and the taxpayers have had difficulty coping with these changes.

We don't need still more changes in the taxation of foreign operations. We do need stability in the tax law. Even if the changes the Treasury is proposing were good there would be a strong argument to leave these provision alone.

The fact is, however, that the Treasury proposals are bad. They propose drastic changes in the foreign tax credit, the sourcing of income and the allocation of expenses. The proposed tax changes will make the law less simple, less fair, and lead to less growth.

In the real world the proposals would result in double tax, cause non-competitiveness for U.S. companies, hurt prospects for economic growth and complicate the administration of the law for taxpayers and the Internal Revenue Service alike.

I would like to comment today on the per-country proposal and the changes recommended for the allocation of interest expense. Other witnesses I am sure will address other aspects of the proposals.

Foreign Tax Credit

I believe that we should not change from the overall to the per-country method, especially the novel, hybrid and complex method proposed by Treasury.

The celebrated authority on this subject, Elisabeth A. Owens in her book The Foreign Tax Credit, (Harvard Law School, Cambridge, Mass., 1961) at page 313 states:

> The overall limitation is also clearly preferable in terms of administrative simplicity; it provides a greater degree of internal consistency in the tax credit system; and it probably conforms more closely with the attitude of taxpayers towards the basic problem presented by the simultaneous imposition of foreign and United States taxes.

In 1960 when taxpayers were most recently given the right to use the overall method, the House Committee on Ways and Means said:

> In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat this domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation.

In 1975 the staff of the Joint Committee in a report prepared for the tax writing Committees of Congress concluded:

> These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group.
>
> Report prepared for the use of the Committee on Ways and Means by the Staff of the Joint Committee on Internal Revenue Taxation, September 27, 1975, p. 20.

The House Ways and Means Committee established a Task Force on Foreign Source Income in 1976, chaired by Mr. Rostenkowski, and issued its report in 1977 which stated:

> In many instances ... averaging of foreign taxes would appear to be appropriate. Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.
>
> Ways and Means Committee Report 81-788, March 9, 1977, p. 35.

The evolution of the U.S. taxation of foreign source income and the influence of such people as Stanley Surrey and Larry Woodworth on its development are set forth in an excellent article by Stanford Ross reprinted in Tax Notes on February 18 of this year. Mr. Ross states:

> The overall limitation of present law is largely a product of compromise designed to achieve some degree of equity without undue complexity. It allows averaging among high and low tax foreign income, but restricts the benefits of foreign losses, which were perceived as a problem when taxpayers had an election as between the overall and per-country limitations. The tracing of income, deductions and foreign taxes that would be involved in the per-country limitation would add very greatly to the complexity of the tax law, the very consideration that led to the enactment of the overall limitation. Tracing would make quantum additions to the uncertainty of compliance and administration in the international tax area. It remains to be seen whether such tracing is even feasible, and the Treasury proposals in the international area offer little evidence of concern for compliance and administration.

Our position that the Treasury proposal on the per-country issue should be rejected is consistent with that of the leading tax authorities. The proposal to change the overall limitation method on foreign tax credits to a per-country method is also opposed throughout the business community.

The Treasury is not recommending a return to the per-country method that was used in the past in the United States and is used today in some foreign countries. The proposed hybrid method is much worse than the old per-country method because it puts taxpayers on per-country for income and on overall for losses and because it would require the most incredible tracing of foreign income, foreign expenses and foreign taxes.

The question naturally arises "Why does the Treasury seek to eliminate the overall limitation which has been available or mandated for more than 25 years?" The Treasury offers no satisfactory explanation except that it seems to believe that if the corporate rate is reduced from 46% to 33% U.S. multinationals will be more likely to move operations out of the United States and set them up in low tax foreign countries. I would have thought that a U.S. rate reduction as such would make this less rather than more likely from a theoretical point of view. In any event our experience suggests that the concern is not a practical one in the real world. U.S. companies do not make foreign investments in lieu of domestic investments because a foreign country has a low tax rate. In the case of Mobil our investments are related to where we can sell gasoline and other petroleum products. Logistics suggest where we should build a refinery and we invest in exploration and producing where we believe the oil is. I think other industries have similar experiences. According to the Department of Commerce 87% of U.S. investment abroad at year-end 1984 (exclusive of banking and insurance) was in countries with tax rates greater than 33%. As summarized by Mr. Ross in his article:

> The principal justification for the per-country proposals is that with a proposed 33 percent corporate rate, the per-country limitation is vital to prevent increased overseas investment in low tax jurisdictions in order to use up excess foreign tax credits from high tax jurisdictions. A belief is expressed that the per-country limitation is correct tax policy because it relates the U.S. tax system to a particular foreign system on a bilateral basis. But that belief is no more persuasive than the belief that we live in a multinational economic world and the overall limitation provides a better method of interrelationship for the U.S. with many tax systems worldwide. The justification for the change ultimately needs to take account of a host of economic and practical considerations that are largely left unanalyzed in the Treasury study.

If there is any specific tax avoidance problem that might create concern with the overall method it can be remedied in the way Congress has traditionally addressed that kind of problem without radically restructuring the foreign tax credit.

And now for a few moments on the proposal regarding the allocation of interest expense.

Allocation of Interest Expense

The Treasury interest allocation proposal would deem that money borrowed by one member of a consolidated group operating in the U.S. was in part borrowed by another member of the group operating abroad, even if the fact were that the borrowing company needed to borrow and did borrow to make the U.S. investment and the affiliate operating abroad had no need to borrow and did not borrow.

In Mobil's case bonds issued by Mobil Alaska Pipeline to build its share of the Alyeska Pipeline would be deemed to have been issued in part by Mobil Oil Indonesia. The Treasury proposal would treat Mobil Alaska and Mobil Oil Indonesia as if they were not separate companies and would not allow us to trace the borrowing to Mobil Alaska, the company that actually borrowed the money. The Treasury proposal is illogical, ignores the real world, is contrary to tax practice that has been carefully considered for 20 years and would make U.S. multinational companies less competitive in making U.S. investments compared with purely domestic companies, or companies operating in the U.S. or abroad owned by foreign multinationals.

Under current law, interest, like other deductions, is allocated on a separate company basis which in the real world is a reasonable and relatively simple proxy for complex tracing rules. Contrary to Treasury's notions of consolidated fungibility, separate company debt does reflect the real world.

The Treasury Proposals would penalize U.S. investment by U.S. multinationals

Several years ago our subsidiary, Mobil Oil Indonesia, explored for oil in Indonesia. Fortunately we found a large gas field in Northern Sumatra. When it came time to develop the field, Mobil Oil Indonesia borrowed a large amount of money from an international consortium of banks. The operation was successful and the banks were repaid out of the income from the project. The operation has continued to be successful. Mobil Oil Indonesia now has very substantial assets in Indonesia all of which have been financed out of cash flow from Indonesian operations. Mobil Oil Indonesia at the current time has no need to borrow money. In fact, it remits very significant dividends to Mobil, yet under the Treasury's proposed rule the money that another subsidiary, Mobil Alaska, borrowed to build a pipeline in Alaska would be deemed to have been in part borrowed by Mobil Oil Indonesia. Let me assure you that the government of Indonesia is not going to allow Mobil Oil Indonesia to deduct interest incurred by Mobil Alaska. Under the Treasury proposal, because Mobil Oil Indonesia had successfully invested in Indonesia, Mobil Alaska would not receive a full U.S. tax benefit for its interest expense in the U.S. and its after-tax costs of borrowing to build its share of the Alaska pipeline would therefore be higher than those incurred by its competitors. Take, for example, SOHIO and BP. SOHIO operates primarily in the U.S. and therefore interest incurred on its borrowing to build its share of the Alaska pipeline would be deductible from U.S. income and would not be allocated to foreign operations. BP operates in Alaska through a U.S. subsidiary but the parent company is British. Therefore the borrowings by BP's U.S. subsidiary would also not need to be allocated to BP's foreign operations because they are owned by a British company, not a U.S. company.

Another example I think will make even clearer the bizarre practical consequences of the Treasury proposal. As you know, Mobil Corporation borrowed money and bought Montgomery Ward, a domestic retailer. Under the Treasury proposal the money that Mobil borrowed to buy Montgomery Ward would be treated in part as borrowed by Mobil Oil Indonesia. But it is even worse than that. Montgomery Ward itself has to borrow a great deal of money in order to be in a position to carry inventories and to be able to sell lawn mowers to customers in Chicago, Illinois. As you know for financial and policy reasons we have been very careful to keep Montgomery Ward's debt separate from debt issued by Mobil companies. Nevertheless, under the Treasury proposal, the debt that Montgomery Ward incurred to carry the U.S. lawn mower inventory and finance the sale to a customer in Illinois would also be deemed to have been borrowed in part by Mobil Oil Indonesia. This is an absurd result. J. C. Penny would not have this problem because it has little or no foreign operations. Marshall Field would not have this problem because while it is now part of a multinational operation, it is not owned by a U.S. company but by Batus, a British multinational company. Why should Montgomery Ward be handicapped in selling lawn mowers in Chicago just because Mobil Oil Indonesia has a successful venture on the other side of the Pacific Ocean?

The Treasury Proposal would overturn 20 years of practice

How a group of corporations filing a consolidated federal income tax return should allocate and apportion deductions has been studied and restudied by Treasury. Each time, Treasury has concluded that all deductions, including interest, should first be allocated and apportioned by the separate corporation which incurred them, and the resulting incomes aggregated for purposes of calculating the consolidated limitation under section 904 of the Code.

The separate company rule was first promulgated in 1966 as § 1.1502-4(d) of the Income Tax Regulations dealing with consolidated returns:

> (1) Computation of taxable income from foreign sources. The numerator of the applicable limiting fraction under section 904(a) shall be an amount . . . equal to the aggregate of the separate taxable incomes of the members from sources within each foreign country or possession of the United States (if the per-country limitation is applicable), or from sources without the United States (if the overall limitation is applicable). (Emphasis supplied.)

This was the culmination of a comprehensive project which began April 30, 1965 and included public review of and comment on Proposed Regulations published October 1, 1965.

Treasury next considered this question in Rev. Rul 72-281, 1972-1 CB 285:

> Consolidated taxable income is, thus, the aggregate of the separate taxable incomes or losses of each member of the group. The regulations make no reference to consolidated foreign source gross income or to consolidated gross income. The gross to gross ratio of section 1.861-8(a) of the regulations should therefore be applied to expenses of each member of a group which cannot definitely be allocated to some item or class of domestic or foreign sourced income on a separate company basis, i.e., the ratio of gross income of a particular member from foreign or domestic sources over gross income of that particular member from all sources.
>
> Accordingly, for purposes of computing the consolidated limitation on the foreign tax credit, the numerator of the applicable limiting fraction, under section 904(a) of the Code (consolidated taxable income from foreign sources), should be determined by allocating expenses of each member of the group which cannot be allocated to some item or class of domestic or foreign sources income on the ratio of foreign gross income to total gross income of each company of the group (separate company ratio). (Emphasis supplied.)

Treasury reaffirmed its position in 1977 when it published regulations interpreting section 861 of the Code. § 1.861-8(a)(2) provides:

> If an affiliated group of corporations joins in filing a consolidated return under section 1501,

> the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income.

The separate company approach was also taken by Treasury in 1984 in § 1.936-6(b)(1) of the proposed regulations under section 936(h) regarding possessions corporations.

We think that Treasury was right in 1966, 1972, 1977 and 1984 and that the present rule is sound. It is consistent with the general thrust of the consolidated return regulations to respect separate corporate identities. It is also consistent with the fact that borrowings are done in separate corporations for valid business reasons.

Contrary to Treasury's undocumented assumption that U.S. companies borrow in the U.S. in order to invest abroad, our experience is the reverse. In Mobil's case cash from foreign operations is financing domestic activities and it would be absurd to attribute U.S. borrowings to foreign operations.

I would be pleased to answer any questions you may have.

October 2, 1985

STATEMENT SUBMITTED TO
THE SENATE COMMITTEE ON FINANCE
BY THE NATIONAL FOREIGN TRADE COUNCIL, INC.
REGARDING THE EFFECT OF
THE PRESIDENT'S TAX REFORM PROPOSALS
ON FOREIGN TRADE

The National Foreign Trade Council, an association of over 500 companies engaged in all phases of international trade and investment, supports the objectives of the President's proposals: fairness, growth and simplicity; but the Council feels that the objectives are not achieved by certain of the proposals that would impair the ability of U.S. businesses to successfully compete against their foreign counterparts.

The adoption of the four proposals discussed below would increase tax costs for U.S. businesses, placing them at a competitive disadvantage in the international marketplace, both here and abroad. The four anti-competitive proposals are:

1. Foreign Tax Credit

The proposal would switch the limit on the foreign tax credit from the overall to the per-country method, expand the separate basket rule to new kinds of so-called passive income and change the rules for determining the geographic source of income and expense. In each case, the effect would be to reduce the value of the credit.

In support of these changes, the description of the proposal maintains that for the purpose of computing the limit on the foreign tax credit, the foreign operations of a U.S. business enterprise should not be lumped together under the overall method but should be separated by country under the per-country method, because decisions to invest in particular countries are based on the tax structure of the particular countries. To the contrary, much more so than the per-country method the overall method elevates the relative importance of economic factors over tax factors. Accordingly, under the overall method political stability, sound banking and currency, supply and cost of labor, access to raw materials, tariffs, regulatory climate and other economic factors determine where investments will be made, whereas the tax regime is only one of many factors and in most cases a relatively minor one at that. In fact, it is the per-country method that exalts tax factors, with the undiluted tax system of potential host countries becoming more, if not most, important.

No longer is the rationale being advanced that the per-country method should be used because competing foreign countries use that method. Nonetheless, it is instructive to point out that in fact some foreign countries use a form of the overall method, and still others go a step further and prevent double-taxation by exempting foreign income from tax altogether. Accordingly, a change to the per-country method is not warranted on this basis; if anything, the comparison suggests a liberalization of the overall method.

U.S. tax policy on the credit has changed over the years. After lengthy and comprehensive study, the overall method was selected over the per-country method during the 1970's. Without extensive deliberations, this decision should not be reversed. To do so will increase cost and unwisely burden U.S. but not foreign products. The result will be an adverse impact on the U.S. trade balance and consequently on U.S. jobs.

The per-country method would also adversely impact on the U.S. balance of payments. Especially when coupled with proposed changes that would convert foreign sales income into U.S. income, the per-country method would discourage sales into higher tax foreign countries. The payment balance would also suffer because the per-country method would discourage the repatriation of earnings of foreign affiliates in low as well as high tax rate countries, repatriation from the former creating incremental current U.S. tax and the latter incremental lost credits. The upshot will be increased debt financing at the expense of healthier internally created equity financing.

In addition to the weak growth rationale for the proposal to switch to the per-country method, it fails to meet the other criteria of simplicity and fairness.

With respect to simplicity, the proposal would have the opposite effect, requiring U.S. firms to create and maintain numerous new sophisticated records to support a vastly increased number of discrete computations necessitated by the per-country two-basket method. By changing the rules for determining the source of income and expense and requiring passive and operating income to be put into different separate baskets for each different country, the proposal adds enormous complexity to an already complicated record keeping system. The upshot of resulting multiplication of costly bureaucracy, both for taxpayers and the Internal Revenue Service, might be increased foreign taxes paid to foreign countries whose income has been changed. No increased U.S. tax would occur. Such a result would be counterproductive.

With respect to fairness, it is not achieved by treating foreign losses under the overall method while treating foreign gains under the per-country method. Equally inequitable are the proposed changes in the long-standing rules for determining the geographic source of income and expense, which, if adopted, would impose heavy and unnecessary costs on U.S. firms and perhaps induce them to change the way in which they do business. Such a change would result in a loss of U.S. jobs.

The current rules are fair and have worked well in providing criteria for determining the source of income and deductions. They should be preserved.

Finally, the foreign tax credit proposal fails to meet any of the Treasury's stated objectives, but it especially does not promote economic growth; the tax and related costs of the proposal will reduce the pool of capital available to U.S businesses, and increase the cost of capital thereby impairing their ability to successfully compete against foreign counterparts.

The Council recommends that the proposal be dropped.

2. Dividend Paid Deductions

Under the President's proposal a lesser (or no) deduction would be allowed for dividends paid from foreign-taxed foreign income than for dividends paid from U.S. income.

This proposal would diminish the relative investment attractiveness of U.S. firms having foreign operations, thereby increasing the cost of capital for such firms, and ultimately increasing production costs.

The Council recommends that a full deduction be allowed for dividends paid so long as the income source has been subject to tax at a rate at least equal to the U.S. rate.

3. Depreciation and the Investment Tax Credit (ITC)

The proposal would repeal the ITC altogether and, by switching from the Accelerated Cost Recovery System (ACRS) to the Capital Cost Recovery System (CCRS), in some cases cut back on depreciation allowances. Additionally, in the years 1986-1988 the proposal would, in effect, impose an unprecedented retroactive tax at 13% on the so-called excess ACRS depreciation taken in the years 1980-1986.

The effect of these proposals would be to drastically increase the cost of capital, thereby reducing investment levels and jobs. While these provisions would have a very detrimental effect on U.S. operations, they would have even harsher effect on U.S. businesses selling abroad, especially to affiliates. To the extent that foreign taxes exceed the U.S. rate, lowering U.S. tax rates on foreign income of these companies below the foreign rate they pay will not compensate them for these cut-backs in capital recovery allowances.

Together, the current ACRS and ITC provide a capital recovery mechanism which places U.S. firms on a fairly equal footing with their foreign counterparts. Cutting back on the capital recovery rate of U.S. firms would confer an extra advantage on foreign competitors. Both immediate and longer-range, adverse consequences of the proposal would include lower levels of productivity, competitiveness, jobs and U.S. security.

4. Possessions' Income

For qualifying U.S. corporations, after a five-year grandfather period, the proposal would repeal the possessions' tax credit and replace it with a scaled down wage credit.

For many years our tax laws have provided inducements for U.S. firms to institute operations in the possessions. In response, U.S. firms committed substantial capital and other resources to the possessions, especially Puerto Rico. Many of the products of these firms are subject to intense foreign competition. Over the last several years the tax benefits associated with possessions' income have been reduced. The full consequences of these changes have not yet been determined. Elimination of the possessions tax credit would increase the costs of these firms, further eroding their international competitive position. Another consequence would be a reduction in employment in the possessions, with concomitant fiscal and political strain.

The Council recommends that the proposal be dropped.

Conclusion

The foregoing four proposals are defended by the Treasury on the basis that their indicated negative impact is more than offset by the positive impact from tax rate reduction --i.e., that on an aggregate basis under the proposal U.S. tax on foreign income will decrease, not increase. That may be true in some cases, but not on mainstay U.S. companies operating in countries with developed tax systems. To these companies, U.S. tax rate reduction on foreign income is either valueless or must be marked down substantially since their foreign tax rate is 46% or over, or somewhere between 46% and the proposed reduced U.S. rate of 33%.

Accordingly, the proffered defense may apply to passive but not operating type foreign income. To mainstay operating companies the adoption of the foregoing four proposals would increase their tax costs, reduce capital and lower productivity, thereby impairing their competitiveness in domestic and foreign markets. The adverse consequences will increase the U.S. trade deficit; reduce U.S. employment opportunities; and generate unwise new pressures for protection against competitive imports.

National Foreign Trade Council, Inc.

STATEMENT OF BENJAMIN F. MILLER, DIRECTOR, MULTISTATE TAX AFFAIRS AND RULINGS BUREAU, CALIFORNIA FRANCHISE TAX BOARD, SACRAMENTO, CA

Mr. MILLER. Thank you, Mr. Chairman. My name is Benjamin F. Miller. I am an attorney with the Franchise Tax Board in the State of California. The Franchise Tax Board is the agency in California which administers both the personal income tax law and the banking corporation tax law, an agency not dissimilar to the Internal Revenue Service. It is very unusual for us to appear in a setting such as this to testify on a Federal tax proposal.

Normally, we are not concerned with the determinations which the Federal Government may make or the Treasury may make. However, there are specific provisions in the President's tax proposal which we are very concerned with. This concern extends to the foreign tax credit mechanism, rules for sourcing income and expenses between domestic and foreign operations, the replacement of the tax credit system with respect to the possession corporations. All of these things may have a very significant impact upon how corporations report their income for California purposes, particularly in light of the recent working group discussions which have taken place at the Federal level. Also, I would like to indicate that it is a somewhat unusual setting in front of this committee, and that I am presenting the views of a tax administrator as compared to those of a business interest group or even a tax reform group. I am mainly concerned with the administration of the tax laws, not with the effects it may have on investment decisions and things of that nature. The third thing I find unusual as I am sitting here as a representative of the franchise tax board, and I am hearing multinational corporations come in and admit that they do operate as a single integrated enterprise. Now, for purposes of California tax law, when we try to apply the worldwide unitary concept, we find these very same corporations come in and indicate that their international operations are completely separate and distinct from those carried on within the United States. I would suggest that, if you take their statements that they are involved in a single integrated worldwide enterprise and you look to the rules, for example, for sourcing income and very specifically the interest expense allocation, which Mr. Riordan just discussed, I think the approach taken by Treasury is to treat them as a single-integrated, one-business enterprise. And I think that is, in fact, the appropriate approach. Now, I think when you turn to the foreign tax credit and the possession credit mechanism, I view those in a somewhat different light. I think both of those situations certainly create incentives not so much with regard to the investment of income overseas, but with incentives for corporations to assign income to overseas activities. It is this area which I am most concerned with and which I think the Treasury has been most concerned with in terms of their attempts to use section 482 to allocate the income of multinational corporations between domestic and overseas activities. So, from my perspective, if you look at both the possession tax credit and the foreign tax credit mechanism where you have the overall per-country limitation, there is a real incentive for multinational corporations to assign income to overseas activities to take advantage of the foreign tax credits which exist in high tax countries. I think if you eliminate that incentive, you eliminate a lot of the game playing that goes on, the sourcing strategies which are used by multinational corporations in order to take advantage of those items. Finally, in summary, I would like to indicate that very specifically we do endorse both the repeal of the possession tax credit provisions, the modification of foreign tax credit provisions. Second, we want to express our approval of the fact that Treasury is recognizing that multinational corporations do operate as a single integrated worldwide enterprise and that they are taking steps to treat corporations in that manner, and also they are taking steps to eliminate what in State taxes we call nowhere income, which is income not subject to taxation by any jurisdiction. This is particularly exemplified by some of the foreign shipping company rules. Thank you very much for the opportunity to testify.

The **CHAIRMAN**. Thank you, sir.

[The prepared written statement of Mr. Miller follows:]

STATEMENT OF BENJAMIN MILLER, DIRECTOR, MULTISTATE TAX AFFAIRS AND RULINGS BUREAU, CALIFORNIA FRANCHISE TAX BOARD

Mr. Chairman and Members of the Committee:

My name is Benjamin Miller. I am Director of the Multistate Tax Affairs and Rulings Bureau of the California Franchise Tax Board. The California Franchise Tax Board, created by the Legislature in 1929, administers the State's Personal Income Tax Law, the Bank and Corporation Tax Law, and the Homeowner and Renter Assistance Law. The three-member board is chaired by Controller Kenneth Cory. I appreciate the opportunity to appear here today concerning international provisions of the tax reform proposal.

Normally the Franchise Tax Board would not testify either in favor of or in opposition to matters relating to the Federal Tax Law. However, provisions in The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity1/ which concern the reform of the foreign tax credit mechanism, rules for sourcing income and expenses between domestic and foreign activities, and the replacement of the tax credit allowed with respect to the earnings of corporations assigned to activities in the possessions of the United States, principally Puerto Rico, may have a significant impact upon the amount of income United States multinational companies assign to activities in the United States. These items will be of increased significance as states conform to the water's edge recommendations of the Working Group on Worldwide Unitary Taxation because state tax

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1/ The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, May 1985. [Hereinafter cited as the President's Tax Proposal.]

bases will be more directly linked to the federal base. Based upon our experience, we support these reforms and urge the consideration of more comprehensive reforms.

Specifically, we first endorse both the repeal of the possessions' tax credit (Chapter 12.05) and the modification of the foreign tax credit provisions (Chapter 15.01) as a means of reducing corporate incentives to assign income out of the states. Secondly, we express our approval of the tax proposal's recognition of the problems the states have tried to get at through the use of the unitary method, and the steps taken to eliminate what the states have long called "nowhere income," all of which appear in the proposed revisions of sourcing rules for various income and expense items (Chapter 15.02).

The states, unlike the federal government, have always been concerned with the rules involving the sourcing or attribution of income to particular geographic or political areas. This interest arises from the fact that the states can, under constitutional principles, tax only that amount of income which is fairly attributable to activities within their jurisdiction.2/

2/ The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities, even on a proportional basis, unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" Exxon Corporation v. Wisconsin Department of Revenue, 447 U.S., at 219-220, quoting Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S., at 436-437. Container Corp. of

Out of necessity, California and other states utilize the unitary apportionment method as a more effective way to make source determinations. A doctoral thesis submitted to the Law School of the University of Michigan presents the most thorough comparison of the arm's length standard and unitary apportionment. It concludes:

> The arm's length system is theoretically unsuited to the task asked of it. It is an extremely difficult standard to apply and administer. There is strong evidence that it is not very effective in meeting its goals of tax base protection. ... It is submitted that unitary apportionment is superior, in terms of its theory, and can be made to be superior in terms of its application. It would better protect the tax base, be easier to administer and much less open to abuse by taxpayers. It should provide the basis for international tax harmony.3/

Treasury and the Internal Revenue Service (IRS), however, have little interest in determining the geographic source of income or expenses. This lack of interest stems from the fact that the federal government can tax all the income, regardless of where earned, of United States corporations. The federal government has had little occasion to be concerned with the taxation of the U.S. activities of foreign-country corporations or the foreign-country activities of United States-based businesses because neither existed to any great degree.

America v. Franchise Tax Board 459 U.S. 1083 (1983).

3/ Harley, Geoffrey. International Division of the Income Tax Base of Multinational Enterprise. Doctoral thesis submitted to the law school of the University of Michigan, June, 1980.

As the economy of the United States has become more international in character, the IRS and Treasury have become more concerned with making source determinations. These concerns have grown because: (1) there are now many more foreign-based businesses, non-U.S. businesses, which have activities within the U.S., and (2) U.S. businesses have become increasingly international in scope.

In taxing foreign-based businesses, the U.S. limits itself to that income which has a source within the United `States. In taxing domestically-based businesses, the U.S. can reach all of their income. However, provisions for foreign tax credits, the special treatment provided for various foreign sales and the deferral of the taxation of certain foreign income all make sourcing determinations important.

Initially, the IRS relied on Section 482 of the Internal Revenue Code to combat corporate sourcing manipulations. This section provides the Service with the authority to adjust intercompany transactions to reflect prices or charges which would have existed if the transaction had taken place between unrelated parties. This method is known as the separate accounting or arm's-length standard. As sourcing determination became more important in calculating tax, corporate strategies became more sophisticated. To combat corporate efforts, the Internal

Revenue Service developed a complex set of rules and regulations under Section 482 for arm's-length audits and expanded audit activities. Audits of this type are difficult, bewildering and frequently impossible to complete effectively. Experience has indicated that corporate tax planners are able to devise strategies which effectively counter each new effort initiated by the tax administrator to prevent the assignment of income to low tax jurisdictions.

In 1962, the Congress, at the urging of President Kennedy, enacted Sub-part F of the Internal Revenue Code4/ which specifically recognized that transactions with certain tax haven jurisdictions could not be adequately policed under the arm's length method. In spite of subsequent amendments to Sub-part F, to other provisions of the Code, and to the regulations, the results of the efforts of the IRS to source income still remain unsatisfactory.

In September of 1981, the General Accounting Office delivered a report to the chairman of the House Committee on Ways and Means concluding that the arm's-length method worked in only 3 percent of the cases and suggesting Treasury consideration of

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4/ Sections 951-964. Internal Revenue Code Public Law 84-834.

greater use of apportionment formulas.5/ The arm's length method has also come under attack from the academic community as noted by the Harvard Law Review in April of 1976: "the use of the arm's length standard of the current Section 482 regulations [of the Internal Revenue Code] has been accompanied by serious problems." Similarly, the Harvard Business Review referred to separate or arm's length accounting as "the bent measuring stick for foreign subsidiaries."

While we believe the unitary method is superior to the arm's length approach, it has come under extensive criticism from multinational corporations and, through their efforts, from various foreign governments. Because of pressure applied by these entities, it appears unlikely that the federal government would be prepared to adopt the unitary method at this time.

A by-product of the foreign criticisms of the states' use of the worldwide unitary method was the convening of the so-called "Working Group" which met during the latter part of 1983 and early 1984 to attempt to resolve foreign concerns over the states' use of the worldwide unitary method. The Working Group included representatives6/ of eight states, eight multi-

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5/ IRS Could Better Protect U.S. Tax Interest in Determining the Income of Multinational Corporations United States General Accounting Office, September 30, 1981, GGD-81-81.

6/ Members of the Working Goup included: Treasury Secretary Donald Regan (Chairman); Robert Hawkins, Chairman, Advisory Commission on Intergovernmental Relations; Norma Pace, Senior national corporations and several representatives of the federal government, including Treasury. We believe the recommendations of the Working Group demonstrate that both the state and corporate representatives recognized that the taxation of possession corporations, the allowance of foreign tax credits and the sourcing of income and expenses are major problem areas under current federal practices.

The Working Group recommendations recognize the appropriateness, under certain circumstances, of including domestic international sales corporations (DISCs), foreign sales corporations (FSCs), possession corporations, and tax haven activities in a worldwide combined report. These recommendations are premised upon the realization that the current rules with regard to special tax entities create significant incentives for artifi-

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Vice President, American Paper Institute; Charles McCarty, Chairman and Chief Executive Officer, BATUS, Inc.; Governor George Deukmejian, California; Robert Gilmore, President, Caterpillar Tractor Co.; Clifton Garvin, Jr., Chairman, Exxon Corporation; Speaker H. Lee Moffitt, Florida House of Representatives; Philip Caldwell, Chairman and Chief Executive Officer, Ford Motor Company; John Opel, Chairman and Chief Executive Officer, IBM Corporation; Governor James Thompson, Illinois; Kent Conrad, Chairman, Multistate Tax Commission; Owen Clarke, President, National Association of Tax Administrators; Senator David Nething, Vice President, National Conference of State Legislatures; Speaker John Tucker, New Hampshire House of Representatives; Edmund Pratt, Jr., Chairman, Pfizer, Inc.; Peter Magowan, Chairman and Chief Executive Officer, Safeway Stores, Inc.; Allen Wallis, Under Secretary of State for Economic Affairs; Governor Scott Matheson, Utah; John Svahn, Assistant to the President for Policy Development, The White House.

cially assigning income and that current enforcement tools available to the IRS are inadequate to prevent abuse.

The solution proposed by the President's Tax Proposals in eliminating the current possession tax credit and requiring per-country computation of foreign tax credits will greatly reduce the tax incentives which now exist for shifting income. It will not totally eliminate these incentives, and it is certainly not a final solution to a major tax avoidance opportunity, but it is a step in the right direction.

The President's proposal includes changes to the current sourcing rules for various items of income and expense which we support, not as final solutions, but as movements in the right direction.

While we take more comfort from the arguments advanced in support of the President's program than we do in the solutions proposed, we nonetheless strongly endorse them.

In four instances, Treasury justifies changes on the basis of arguments which have been advanced by the states for years.

First, Treasury admits that current rules which divide the income realized from the manufacture of a product in one jurisdiction followed by a sale in another jurisdiction frequently do not reflect the economic activity inherent in producing income.7/ It was this circumstance which first gave rise to the states' use of the unitary method. As noted in Underwood Typewriter v. Chamberlain,8/ it is virtually impossible to divide the income under any separate accounting mechanism. As explained by the United States Supreme Court:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut, and ending with sale in other states. In this it was typical of a large part of the manufacturing business conducted in the state. The legislature, in attempting to put upon this business its fair share of the burden of taxation, was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders.9/

The solution adopted by the state and accepted by the Court: the unitary method.

Second, in proposing a reform of the rules for the allocation and apportionment of interest expense, Treasury notes that money is fungible10/ and that with regard to commonly controlled entities, it is irrelevant who borrows the money in determining where it will be used. Under the

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7/ The President's Tax Proposals, p. 387.

8/ 254 U.S. 113 (1920).

9/ 254 U.S. at 120-121.

10/ The President's Tax Proposals, p. 398.

current rules, interest expense is dealt with on a separate-company method which "enables taxpayers to artificially limit the interest expense allocated to foreign-source income by simply manipulating the location of borrowing within a consolidated group."11/ Therefore, Treasury proposes that the interest expense of all members of an affiliated group be accumulated and apportioned against all taxable income. Treating commonly controlled entities as a single business is one of the fundamental attributes of the unitary approach. It is fair, sensible and correct.

Third, Treasure notes inconsistencies in the sourcing of income from the licensing of intangibles as compared to the sales of intangibles.12/ It is these inconsistent rules which have led to the exploitation of the possession's credits and have given rise to significant controversy between the taxpayers and the IRS.13/

Finally, with respect to transportation companies, Treasury shows awareness of the problem which has haunted state tax administrators for years: that is, "nowhere

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11/ Id. at p. 401.

12/ Id. at p. 400.

13/ E.g. Eli Lilly Co. v. Commissioner, 373 F2nd 990 (Ct. Cl., 1967).

income." Specifically, in the transportation area,14/ and also in the taxation of "80/20" corporations,15/ Treasury recognized that the sourcing rules employed by different countries are manipulated by corporations so that large amounts of income are received tax free. Treasury is finally moving to close these loopholes. The Franchise Tax Board applauds Treasury's effort.

In summary, the Franchise Tax Board is pleased that the President's Tax Proposals finally recognize that the problems the states have experienced for years in attempting to audit and tax international corporations are not unique to the states but exist at the federal level as well. We believe the President's proposals have correctly identified and eliminated some of the incentives to assign income out of the United States. The arguments advanced in support of the various reforms of the sourcing rules demonstrate a growing awareness of the concerns the Franchise Tax Board has expressed for years and a willingness to address these problems.

The water's edge recommendations of the Working Group and the subsequent movement away from worldwide combination by many states will force the states to increasingly rely on the federal government for protection of their corporate tax base. It is therefore critically important from a state perspective that Congress adopt the loophole tightening provisions advanced in the President's Tax Proposals.

14/ The President's Tax Proposals at 401.

15/ Id at p. 403.

The **Chairman**. Senator Pryor.

Senator **Pryor**. I have no questions, Mr. Chairman. I appreciate these witnesses this morning coming here. Thank you.

The **Chairman**. I want to follow up on Mr. Miller's statement that multinational companies should be treated as an intergrated business with worldwide operation. The reason I ask is that Oregon just repealed their unitary tax 8 or 9 months ago, and I am familiar with the arguments that he raised because I went through them with our Governor. I wonder if you might start, Mr. Furlaud, and respond to the inconsistency that the same multinationals who want to be considerated an intergrated enterprise, for purposes of the per-country limitation versus the overall limitation, make argue the exact opposite to argument to States who were considering the unitary tax.

Mr. **Furlaud**. Mr. Chairman, contrary to the last speaker, of course, I am very concerned with the economic effects of taxation. And I think that as a policy matter that is really one of the most important areas that we can focus on. One of the problems with the States imposing the unitary tax, as I understand it, is that if every State and every municipality is going to tax every international business on all aspects of its worldwide income pursuant to some kind of allocation rule, that is going to create an absolute horror of complexity. And I feel that it is just very bad public policy for each State to try and tax every entity that does business in its jurisdiction on all of its income, based on some kind of an allocation formula. And if one State starts it, others will in fact do it, and I am just kind of comforted by the fact that I believe that most States are now moving in the other direction and that——

The **Chairman**. Let me ask this: I know they are moving in the other direction, and I understand why, because many of the multinational companies have said we are going to leave your State. California may be faced with that problem, and that is a political decision you will have to make, Mr. Miller. But it is true, isn't it, in dealing with the unitary tax States, you often use the argument all the time: We are a unitary business, worldwide, and we operate on a unitary business.

Mr. **Furlaud**. And of course, you have to look at your business as a total business; but when you, for example, look at the foreign tax credit, you must remember that when you are in Germany, for example, you are actually paying German taxes. You are paying a tax—you are not getting credit for something you haven't paid. You are applying that; and if you don't get that credit, you are going to be taxed twice. And the problem with the per country limitation is that the effect of that is that you cannot take advantage of the low tax country to reduce your overall tax rate. So, the effect of that is to raise your tax rate in the United States and put you at a very serious competitive disadvantage.

The **Chairman**. I am going to pursue this in a slightly oblique way. Mr. Rau, on page 4 of your written statements you say:

> The Administration also hyperbolically assumes that investment decisions are motivated principally by tax considerations. Our collective experience teaches us, however, that investment decisions, especially those concerning operating assets, are based on economic opportunity and competitive pressures.

And when you say "operating assets," I assume you mean factories or something like that.

Mr. RAU. Correct.

The CHAIRMAN. Rather than tax considerations?

Mr. RAU. Correct.

The CHAIRMAN. Then, before the Ways and Means Committee, Mr. Furlaud, you responded somewhat along the same lines. You were asked what effect tax rates and rules have on a company's decision to locate, and your response was that it had little to do with the company's decision to locate. Would it make any difference to the pharmaceutical industry, therefore, if we repealed the possessions tax in Puerto Rico?

Mr. FURLAUD. It would be absolutely catastrophic.

The CHAIRMAN. Why, if it isn't a factor in your location?

Mr. FURLAUD. Because if you are going to serve a market, for example, if you are going to be in Europe, you go to Europe in order to take advantage of the European market; and you are producing in Europe in the Common Market for your European market. Now, once you are in Europe, then you will naturally go to the area which is the most advantageous; and you may because if the Europeans set up a system, say, in Ireland where they encourage you to go to Ireland because it is a somewhat lesser developed part of Europe, you would take advantage of that. And you, therefore, locate your plant in Ireland. And that is the exact analogy with Puerto Rico. You are not in the United States to save taxes. You are in the United States to do business; but once you are in the United States, you want to go to an area where you have the best tax advantages.

The CHAIRMAN. So, the answer is basically that when you are inside the market, you might choose to locate in Arkansas rather than Pennsylvania if Arkansas had better tax advantages?

Mr. FURLAUD. Indeed, yes, sir.

The CHAIRMAN. All right. Now, Mr. Riordan, in Mobil, to the best of your knowledge, has there ever been any discussion about sourcing of income or where to allocate assets based upon tax laws? Ever?

Mr. RIORDAN. All the time, we have to consider what the requirements of the law are. Every expense that we have under the law, we have to consider what is the appropriate sourcing for that in order to do our calculation.

The CHAIRMAN. Let me rephrase the question. Is there ever any discussion of attempting to allocate an expense or income to a particular country because of that country's tax situation, regardless of whether or not the actual work was done there?

Mr. RIORDAN. No.

The CHAIRMAN. Never?

Mr. RIORDAN. What you are trying to do is comply with the law as it exists. You are also going to plan your activities in order not to maximize your taxes. The complexities of the foreign provisions are a day-to-day experience for all of us, but this constant use of words like "manipulation" or "loophole," is trying to set up an atmosphere which is not the way business is done. We are struggling to try to figure out what we have to do to comply with the law, and we are also going to organize our affairs not to increase our taxes.

In California—I would just like to say something that would apply to Mr. Miller—in the beginning, it did seem a little unusual that he was here; but the more you thought of it, the more you realized the same philosophy that comes out of the Treasury proposals and the Ways and Means Committee options is the same philosophy that you find in the California unitary tax. I think ultimately if those proposals were adopted, they would do for the United States what the unitary tax is doing for California. What it is doing is keeping jobs from going to California, and it is keeping assets from being placed in California. In our own case, there was a time when we had a great big office building in downtown Los Angeles filled with Mobil people who were responsible for handling our West Coast operations. And now, there has been a constant movement of those employment opportunities out of California and assets out of California and moving off to States that do not try to impose their tax jurisdiction on income that has nothing to do with their State. For example, California taxes our business in Indonesia even though the natural gas was discovered in Indonesia, is liquefied and is moved to Japan. Yet, it comes into the California tax net under the way they do the unitary tax, and that is why people are reluctant to invest in California and are reluctant to make jobs. And the same thing will happen to the country in my opinion if we go down the route that the Ways and Means Committee is proposing.

The CHAIRMAN. You might be amazed of the extent of my appreciation if you move that building to Oregon. [Laughter.]

Mr. RIORDAN. Senator, the action that the legislature in Oregon took is going to make it more likely that there will be jobs and assets in Oregon and maybe some of them will move from California if California doesn't do the same thing that Oregon has done.

The CHAIRMAN. Mr. Miller.

Mr. MILLER. Yes, if I could respond to that, I would suggest that the committee might like to look at the statistics of economic growth, new investments which occur in individual States; and I think if you look at them for the past 10 or 15 years, or perhaps longer, you will discover that California probably is the leading State every year in attracting new investment and attracting new foreign investment, which have been some of the most vocal critics of the use of the unitary method. We may not be number one every year, but I think we probably are, but two or three; and I think if you look at last year, it will be very interesting to discover that the State of Florida, which went through a huge furor over the adoption of the unitary method and the subsequent repeal, with many charges or claims by corporate business, they would not invest in Florida with the unitary method. I think the year that they had the unitary method is probably the best single year they have ever had in getting new investment in the State.

The CHAIRMAN. Let me ask you this, and I don't mean it in any derogatory sense, but California sort of is an 800-pound guerrilla. And I would expect businesses would go there where they might not otherwise go to another State that had a unitary tax system, but is California No. 1 over the last 5 or 10 years per capita? Or is it simply No. 1 because you are an immense and wealthy market?

Mr. MILLER. I don't know the per capita figures. I will see if I can get them for you, though.

Mr. RIORDAN. If I could just make a comment?

The CHAIRMAN. Yes, sir.

Mr. RIORDAN. California has just recently considered and did not take action on the unitary tax, but what they were considering is the same kind of thing that you find buried in these proposals. California almost passed a law that would have relieved foreign multinational from the adverse consequences of their unitary tax but would not have relieved U.S. companies. So, they would have given relief to Shell, but not Exxon. Another consequence of what California has done with the unitary tax is we now have the British Government so incensed over the way the subsidiaries of British companies are being treated that the British Parliament has passed a law. All American companies that do business in California are now subject to retaliatory taxes in the United Kingdom——

The CHAIRMAN. Wait a minute. All American businesses that do business in California?

Mr. RIORDAN. In California.

The CHAIRMAN. That is all American businesses, isn't it?

Mr. RIORDAN. It certainly includes us, and it includes an awful lot of other companies. I guess there are some that don't do business in California, are now held ransom in the United Kingdom because they are so angry at what they regard as the inequity of the California unitary tax as it applies to subsidiaries of British companies, so that now the British tax law is going to be applied in a penal way against American companies doing business in the United Kingdom. That is what this kind of mindset ultimately produces.

The CHAIRMAN. Let me warn you about what I think may happen then. Treasury will document—I think with pretty good evidence—abuses of the present foreign tax rules; and if you really tell me that you have never heard of any or never knew of any, I think you are operating in a vacuum.

Mr. RIORDAN. You know, when Treasury does this, it would be awful nice if we could have everybody there to review it at the same time. There is no doubt if you set up a very complicated system, there will be times when the results will be such that you will say: I didn't really intend that result. But Congress has been very quick and Treasury has been very quick to recommend specific protections if they think there is an abuse. It is not always so clear. For example, they are now proposing in the Ways and Means Committee something that would apply to marine income. Well, now, there is a policy question you have to decide. Do you want U.S. companies to be in the marine business, if the principal fact of life in international commerce is that marine activities—let's say Greek shipowners—are not subject to income tax. That is a policy decision. If you want to be subject to immediate U.S. tax, you are going to do for the foreign flag fleets of American companies what we have already done to the U.S.-flag fleet of American companies. You are just going to push the Americans out of business. And this idea of having a more favorable rule because it is a foreign multinational than it would be if it was a U.S. multinational is, I think, shooting ourselves in the foot, when we have got the kind of international competitive situation we face.

The **Chairman**. You are right, but that argument applies to everything, you know. The arguments about overseas corruption, and we can't engage in it and other countries do; and we ought to repeal it because they do, and we are, therefore, at a competitive disadvantage. Is that a valid argument?

Mr. **Riordan**. I think that we should stand true to our own principles, but we are not on this globe all by ourselves. And we have to recognize that we have to make a judgment. If we want to impose higher taxes on U.S. companies than are going to be paid by foreign companies, then we shouldn't be surprised if we end up having our friends in the trucking industry pick up a box that was shipped from Japan with a Japanese appliance rather than picking it up at an American factory.

The **Chairman**. And we shouldn't be surprised if we lose an arms sale because of the Foreign Corrupt Practices Act because we could not pay a bribe that a foreign country could?

Mr. **Riordan**. I don't know the facts on that. I think it is regrettable if, for any policy reason, we can't participate in international commerce. I wish that it was that everything could be done free open competition. I don't know about bribes, but I think a lot of times we impose policy restrictions on ourselves—antitrust and otherwise—that make it very difficult for American business to compete on a level basis with institutions of other nations. With the kind of trade deficit we have, I think we ought to revisit that attitude.

The **Chairman**. You look like you want to say something, Mr. Furlaud.

Mr. **Furlaud**. No; I have been listening attentively, Mr. Chairman. I would like to say that the deficit situation that this country is facing is so serious that I think that something really has to be done about that. And I am not speaking on behalf of ECAT in this regard, but just on my own behalf. And while it is very interesting to talk about the niceties of the foreign tax credit, really this country is facing a very, very serious situation; and I really feel that that should be addressed, and I believe it should be addressed not only through spending cuts, which I think have not been done sufficiently, but also through some kind of a broad-based tax that would pick up some additional revenue. So, I am just making that statement. You asked me if I wanted to say something; I wouldn't have dared say it if you hadn't asked me, but that is what I was thinking. [Laughter.]

The **Chairman**. I ought to congratulate the Emergency Committee. I have used their facts for years, going back to when we had the Burke-Hartkey bill and the overseas deferral of foreign source income; and I found your research and your facts impeccably good. It is a first-rate organization.

Mr. **Furlaud**. Since I have had nothing to do with putting the facts together, I feel very free to feel good in that regard. We have a marvelous staff in Bob McNeill, and his group does a marvelous job.

The **Chairman**. Mr. Miller, I wish you good luck. I don't envy you because I know what Oregon went through with the unitary tax problem and the arguments of businesses. I don't know if the arguments are valid or invalid. We changed, and we will see if we get businesses. You can see if you lose businesses; but I don't envy what you are going through. Gentlemen, thank you very much. We are recessed.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

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Richard L. Thompson
Vice President
Government Affairs

December 5, 1985

Mr. Edgar R. Danielson
Senate Finance Committee
SD-219
Washington, DC 20510

Dear Mr. Danielson:

Enclosed is a reviewed copy of the testimony of Richard M. Furlaud before the Senate Finanace Committee on October 2nd. There was a delay in getting the testimony to ECAT which subsequently was sent to us.

I am also enclosing answers to questions that were submitted by Senator Mitchell which I understand will be included in the Record.

Sincerely,

Richard L. Thompson

RLT/sm
Enclosure

Q. Mr. Furlaud, you say that U.S. investment abroad is not tax motivated. Are you suggesting that your company and others do not invest in Ireland, for example, to take advantage of the tax holiday there?

A. It is important to distinguish between two decisions -- the initial decision whether to expand operations abroad, and the secondary decision in which country to locate the foreign operations. Our company's decision on the first question -- whether or not to invest abroad -- has little if anything to do with tax concerns. We operate abroad for business reasons -- because we want to sell our products there, because we need to conform to foreign regulatory requirements, because we need to operate within the Common Market tariff fence, and so on.

Once we are committed, for business reasons, to operate abroad, our choice of the particular country in which to locate a facility will, obviously, respond to local tax laws. Thus, if Ireland has chosen to provide a favorable tax environment we will, all other things being equal, locate there rather than in Germany, a high-tax jurisdiction. Indeed, we must locate in Ireland, because our competitors will locate there and take advantage of the local tax rules even if we do not. That is why the United States would act irrationally by slapping an additional U.S. tax on the Irish income -- our foreign competitors will be unaffected by the new tax, so that U.S. firms will be at a severe competitive disadvantage.

Q. You said something on page three of your statement which I can't let pass without a question. This is a trade rather than a tax issue.

In defending the overall limitation in current law, you took exception tot he Administration suggestion that current law leads to excessive tax motivated investment abroad. You go on to say that "almost every country has its own version of a food and drug administration which all but forces companies to do business 'in country'." You then say exorbitant tariffs are another problem.

Let me ask you, does the United States impose similar requirements? Are these import restrictions in violation of the General Agreements on Trade and Tariffs? If so, have you ever attempted to challenge these import restrictions? If not, why not?

A. Food and drug regulations, which in many countries are supplemented by government price controls on drugs, do indeed often have discriminatory effect, and we have consistently challenged these effects. Dramatic instances of this kind of challenge have been the many lawsuits and regulatory proceedings over more than ten years that have involved us and other American companies in France, where our industry did succeed in modifying some of the most outrageous features of this discrimination by obtaining a ruling of the European High Court of Justice striking down certain specific regulations as contrary to EEC Law, which in that case also followed GATT principles.

But French, Belgian, Italian, Greek and other European drug regulations still make it impossible to operate competitively in those countries without local manufacture, despite repeated challenges by us and others. Nothing remotely comparable affects foreign drug companies coming into the U.S.

Japan is another dramatic example, where we have challenged discriminatory requirements that force us to develop drugs all over again in Japan, even though they have been proven in the U.S. or elsewhere; only minor progress has been achieved to date in this respect, despite major efforts by our industry and the U.S. Government.

Sadly, some governments are even moving towards greater effective discrimination, as is the case in Canada and Britain, where our industry's currently engaged in a major effort with U.S. government assistance to prevent a serious increase in favoritism towards nationals in the area of price controls for drugs. Beyond this area, Canada has implemented its compulsory license laws which seriously damage protection for intellectual property and thus adversely affects U.S. exports. The Canadian Government, thus far, has not been responsive to this issue in any practical way.

Tariffs are a particularly serious problem in the less developed countries, where they are often exorbitant, and unfortunately tolerated under the GATT. But even a tariff barrier like the EEC's, which is not generally higher than the U.S. tariff, means that U.S. products cannot compete with those made within the EEC, thus forcing us at least to finish our products there and sometimes also to manufacture all of some of the raw materials within the EEC.

STATEMENT OF
CAPTAIN HENRY A. DUFFY, PRESIDENT
AIR LINE PILOTS ASSOCIATION
SUBMITTED FOR THE RECORD OF THE HEARING
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
JULY 31, 1985
ON
THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS
FOR FAIRNESS, GROWTH AND SIMPLICITY

The Air Line Pilots Association appreciates the opportunity to present this statement to the Senate Finance Committee. ALPA represents 34,000 pilots, who fly for 49 airlines, for purposes of collective bargaining under the Railway Labor Act. In the interest of simplicity, we have categorized our comments in four main areas:

(A) Retirement Savings (Chapters 14.01-14.10),

(B) Fringe Benefits (Chapters 3.01-3.04),

(C) Repeal of Deduction of State and Local Income Taxes (Chapter 3.09), and

(D) Imposition of Current Taxation on Life Insurance and Deferred Annuity Income (Chapters 10.06-10.07).

(A) Retirement Savings (Chapters 14.01-14.10)

1. Modify Nondiscriminatory Coverage Test For Tax Favored Retirement Plans - Chapter 14.09

Under the proposal, all pension benefit plans would be subject to a uniform rule requiring the percentage of "prohibited group" members who actually benefit under the plan not to exceed 125% of the percentage of the other employees who actually benefit under the plan. If such percentage of prohibited group members exceeds 125%, the plan cannot constitute a qualified plan.

The proposal recognizes the need to exclude certain employees from consideration, in determining whether the nondiscrimination standard is satisfied. These employees include (1) employees with less than one year of service (except in the case of an employer's health plan); (2) part-time and seasonal employees; (3) employees covered by a collective bargaining agreement; and (4) nonresident aliens who receive no United States earned income. These exclusions are very similar to, and appear to be derived from, the exclusions applicable to determinations of nondiscrimination in qualified plans.

Notably absent from the list of excludable employees, however, are the employees presently described in Section 410(b)(3)(B).

In recognition of the unique position which airline pilots hold in the area of collective bargaining, a specific provision was included in the Employee Retirement Income Security Act of 1974 to protect the qualified status of pension and profit-sharing plans established or maintained on behalf of airline pilots pursuant to collective bargaining. In general, Section 410(b)(3) of the Internal Revenue Code provides that, in determining whether a qualified pension or profit-sharing plan meets the strict eligibility requirements of Section 410, certain employees shall be excluded from consideration. In addition to those who have not met the plan's minimum age and service conditions, employees covered by a collective bargaining agreement and nonresident aliens with no United States earned income, Section 410 shall be excluded from consideration -

> (B) in the case of a trust established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers, all employees not covered by such agreement ... .

Thus, a qualified retirement plan maintained for pilots pursuant to a collective bargaining agreement under the Railway Labor Act may exclude from consideration, in determining whether the discrimination tests are satisfied, all employees who are not covered by the agreement. The result is that qualified plans covering only pilots cover 100% of those employees which must be considered for purposes of meeting the present statutory eligibility requirements.

If a plan covers all of an employer's employees, including the pilots, such as a company-wide profit-sharing plan, the 125% nondiscrimination test is automatically satisfied, since 100% of the prohibited group is covered and 100% of the non-prohibited group is covered, and 100% is not more than 125% of 100%.

If a pension plan covers pilots only, assuming a "pilots only" classification constitutes a reasonable classification on its face, the actual relevant percentage must be calculated in determining whether the plan is discriminatory.

We have attempted to estimate the standing of the collectively-bargained pilot benefit plans under these rules. Our estimate, summarized in Exhibit A to this Statement, shows that no qualified plans covering pilots only would continue to be considered nondiscriminatory under the new uniform rules.

At one extreme, if all pilots are prohibited group members, the benefit plan will always fail the nondiscrimination test. This is because no matter what percentage of the prohibited group the pilots account for, such percentage will always be more than 125% of the percentage (0%) of non-prohibited group members covered by the plan. This situation exists with respect to the pilots employed by Air California, Delta and TWA. As the Exhibit shows, the other pilot groups do not represent much larger percentages of the non-prohibited group. In fact, in most cases, the pilots would account for 45-66% of the prohibited group members. With these percentages, a plan covering pilots only will never be able to meet the 125% test.

ALPA believes this result is intolerable in that it (1) fails to recognize that pilot benefits are by their nature nondiscriminatory in that they are collectively bargained, (2) impairs the value of such collectively bargained benefits, and (3) impedes the collective bargaining process itself.

Pilots have traditionally organized for purposes of collective bargaining, with 50 pilot groups organized at present. (Of these, 49 pilot groups are represented by ALPA.) Through shrewd collective bargaining over many decades, airline pilots have been able to achieve levels of compensation, both direct and indirect, which fairly compensate them for the tremendous responsibility for life, limb and property inherent in the job of being an airline pilot. Because the levels of pilot compensation are high as compared to any particular airline's other employees does not imply that they are unduly discriminatory with respect to the levels of compensation achieved by the other employees.

The collective bargaining process is designed to put parties with disproportionate power for making employment decisions on a more even keel. Thus, benefits resulting from the collective bargaining process are not discriminatory in favor of the employer's decision-making authority, its management. Because such benefits are not easily won, and are the result of much give-and-take in the negotiation process itself they, by definition, do not constitute forms of overreaching executive compensation awarded, by those with authority to make such decisions, to themselves. Rather, the collective bargaining process itself assures that this sort of self-dealing cannot occur.

It is unfair, therefore, to compare what a group has been able to achieve through collective bargaining to the benefits achieved by other employees. Indeed, ALPA, as collective bargaining representative for the pilots, owes no duty whatsoever to employees it does not represent. It is illogical, therefore, to measure benefits won by any one collective bargaining unit with those enjoyed by other employees. To make such comparisons and to have them lead to such illogical results as to have a collectively bargained plan considered discriminatory impedes the collective bargaining process itself.

In view of the strong national policy favoring the collective bargaining process, we recommend that the uniform nondiscrimination rules contain an exemption for any qualified plan established or maintained pursuant to a bona fide collective bargained agreement.

Under the proposal, the "prohibited group" is defined to include any employee who is or within the latest three years (including the year of determination) has been: (1) a 1% or more owner of the employer, considering attribution, (2) an employee with annual compensation of $50,000 or more, (3) an employee in the top 10% of employees by compensation, if he earns at least $20,000, (4) one of the three highest-paid employees, if he earns at least $20,000, and (5) family members of (1) - (4). The $20,000 and $50,000 figures would be indexed for inflation.

ALPA strongly urges that the definition of "prohibited group" be revised to exclude any employee whose employment is subject to the terms and conditions of a bona fide collective bargaining agreement, since these employees are not members of the group of employees with control over corporate decisions, traditionally the group of employees targeted by the nondiscrimination standards.

In addition to meeting the 125% test, any classification of employees used for participation purposes must be nondiscriminatory on its face. The proposal states that a plan which excludes a class of employees based on a bona fide job category would not be discriminatory on its face. The converse should also be true -- that is, a plan which covers a class of employees based on a bona fide job category would not be discriminatory on its face. In this regard, the rul should state explicitly that either a group of employees in a bona fide job category or a group covered by a separate collective bargaining agreement constitute a reasonable classification. Thus, if a plan covered the class of employees consisting of all of the employer's pilots represented for purposes of collective bargaining, the plan would not be considered discriminatory on its face.

In summary, in view of the dire, and we believe, unintended consequences the proposed rule would have on pilot plans, we strongly urge that this Committee

(1) Exclude from the definition of "prohibited group" all employees covered by a bona fide collective bargaining agreement;

(2) Exempt from the nondiscrimination rule all pension benefit plans established or maintained pursuant to a bona fide collective bargaining agreement; and

(3) Incorporate exclusion of Section 410(b)(3)(B) among employees excluded in considering whether among exclusions nondiscrimination rule is satisfied.

2. Increase Spousal Individual Retirement Account - Chapter 14.01

ALPA fully supports the adoption of an annual IRA limit of $4,000 for a married couple, $2,000 apiece regardless of whether one member of the household may earn less than $2,000 annually. This provision will help women who do not woek outside the home attain a measure of retirement security heretofore unavailable to them.

3. Unify Rules for Distribution From Tax-Favored Retirement Plans - Chapter 14.02

ALPA supports the effort to unify the tax rules applicable to the various types of tax-favored retirement plans. Much uncertainty and unnecessary expense will be eliminated in the process. We have a few recommendations, based upon our experience with pilot retirement plans.

Under the proposal, a 20% excise tax would be applied to distributions received prior to death, disability or attainment of age 59-1/2. The 20% tax is reduced to 10% if the distribution is used to pay college expenses incurred by a dependent, for the purchase of the individual's first principal residence, or to replace certain unemployment taxes. We believe the 20% tax should be eliminated in the cited examples, in view of the financial hardhsips they represent.

Under the proposal, the 20% excise tax is eliminated if a distribution made prior to disdability or age 59-1/2, but after age 50, is one of a series of substantially level payments under a single or joint annuity or under a term certain of at least 180 months commencing upon retirement under the plan. This exception is intended to encourage, and not to penalise, the receipt of early retirement benefits. Under pilots' plans, however, the early retirement age is often 45, in view of the federally mandated normal retirement age of 60 applicable to pilots. Thus, the exception should be modified to include all distributions made prior to age 59-1/2, if received on account of early retirement, in accordance with the plan's provisions for early retirement.

Along these lines, the exception from the 20% excise tax for distributions received after disability should be clarified to incorporate the definition of disability under the plan, and not the Social Security definition. Since a pilot must meet very strict physical competency standards, in order to maintain his federal license to fly, he may become disabled from his occupation much more easily than other employees. Thus, a disabled pilot could receive lifetime disability benefits under the plan, commencing at an age well before age 59-1/2. Such benefits should not be subject to the 20% excise tax, in addition to the ordinary income tax applicable to such benefits.

The proposal eliminates the capital gains treatment and ten year forward averaging presently available with respect to "lump sum distributions." One of the reasons cited for eliminating these options is to cut back on incentives individuals have to divert retirement monies from the retirement income stream. However, this view is paternalistic, eliminating reasonable options employees have about their own futures. The other reason cited for eliminating these options is that, since an IRA rollover is available, a tax-favored plan would still be available with respect to monies which otherwise have constituted a "lump sum distribution," promoting tax-favored distributions over an individual's entire retirement period. However, if an employee is covered by both a defined benefit plan, and a profit-sharing plan, his retirement income stream is protected by the defined benefit plan, and his lifestyle goals in retirement can be enhanced by permitting him to employ capital gains and ten-year forward averaging with respect to a full distribution of his funds from the profit-sharing plan. An exeption to the elimination of the capital gains and ten-year forward averaging should apply in such cases. Even if an employee is covered by one plan only, ALPA believes it is unnecessarily paternalistic and without factual basis to restrict employee choice as to tax treatment on the theory that a stream of income over retirement is necessarily better than permitting a lump sum distribution with favorable tax consequences at the time of separation from service.

4. Modify Deduction Rules for Tax-Favored Retirement Plans - Chapter 14.03

Under present law, if an employer maintains both a defined benefit pension plan and a money purchase (defined contribution) pension plan, the employer is entitled to deduct contributions annually, equal to the greater of 25% of covered employees' compensation or the amount necessary to satisfy the minimum funding standards with respect to both plans. In many cases, the amount needed to satisfy the minimum funding standards applicable to the plans exceeds 25% of the covered employees' compensation, and in some cases, can be as high as 35% of the covered employees' compensation.

Under the proposal, where both types of pension plans are maintained, the employer would be limited to an annual deduction of the greater of 25% of the covered employees' compensation or the amount necessary to satisfy the minimum funding standard for the defined benefit plan alone. Thus, if the defined benefit plan cost exceeds 25%, no deduction is available for the money purchase plan contribution which, in any event, must be made because of applicable minimum funding standards. Further, and we consider this preposterous, the amounts contributed in excess of the defined benefit minimum funding requirement would be subject to an annual tax of 10% for as long as the "excess contribution" remains in the plan, notwithstanding the fact that other provisions of federal law require the contributions to be made. The proposal utterly fails to accommodate applicable minimum funding standards where both a defined benefit and a money purchase plan are maintained. This is a very serious problem and must be addressed.

ALPA strongly urges that the present deduction limit be retained in cases where a group of employees is covered by both a defined benefit pension plan and a money purchase pension plan. Contributions required pursuant to minimum funding standards should not be left without a corresponding deduction, and even more unbelievable, subjected to annual excise taxes. ERISA's important minimum funding standards must continue to be honored, and cannot be subjected to open disregard because such required contributions are not deductible.

Through years of collective bargaining, many pilots now participate in both defined benefit and money purchase pension plans. Money purchase plans are the type of defined contribution plan which is sought in collective bargaining precisely because the contributions are subject to ERISA's minimum funding standards and are not discretionary with the employer. In addition, contributions to a money purchase plan are made without regard to the employer's profitability. This is a very important feature for pilots, some of whose employers are experiencing various levels of financial difficulty and unprofitability in the wake of airline deregulation. That money purchase plans are subject to minimum funding standards and are not dependent upon the employer's profit status are two fundamental features of such plans which were apparently overlooked in the proposal. The proposal cavalierly equates money purchase plans with profit sharing and stock bonus plans, since the benefit under each is based entirely on the individual's account balance at retirement.

5. Modify Annual Limits on Contributions and Benefits Under Tax-Favored Plans - Chapter 14.04

ALPA fully supports the elimination of the overall limits applicable to non-top heavy plans. Such limits are too complex to administer, and therefore, constitute disincentives to the establishment of both defined benefit and defined contrbution plans. We recommend that the limits be eliminated for top-heavy plans as well, since plans which are not now top-heavy but which may become top-heavy plans in the future are no more able to administer these complex rules than are plans which are never top heavy.

In substitution of the present overall limits, the proposal would impose a 10% additional tax on the "excess" amount of tax-favored retirement benefits, including IRA distributions, received in any one tax year. The excess is the amount by which the benefits exceed the defined benefit limit in effect that year multiplied by 1.25. Thus, in 1986, an employee receiving $200,000 in retirement income, would have to pay a tax of $8,750, in addition to the ordinary income tax on the $200,000. The $8,750 tax is determined as 10% x ($200,000 - ($90,000 x 1.25)). Although the proposal characterizes the additional tax as a "recapture" tax and not as a penalty tax, we can view it as none other than a penalty tax on an amount of retirement benefit which the proposal characterizes as unreasonable. We do not believe that a plan participant should be penalized for receiving retirement income which was legitimately derived under a qualified plan. Furthermore, mixing in one's IRA distributions is like mixing apples and oranges. An individual should not be penalized because he has the foresight and diligence to accumulate retirement savings of his own, without depending solely upon an employer-provided plan or Social Security, either of which may eventually prove insufficient to pay the benefits earned.

With respect to the separate defined contribution limit proposal, we believe it is inappropriate to consider one-half of all employee contributions for purposes of determining whether the limit is reached. Such contributions, being after-tax, should not be counted against the limit permitted to be contributed without current taxation. The earnings on the after-tax contributions will be taxed upon ultimate receipt, eliminating tax evasion as a possible abuse.

Finally, the proposal would phase in the separate defined benefit limit over a period of ten years of participation, as opposed to a period of ten years of service. The proposal seeks to curb the abuse seen in the establishment of a defined benefit plan by a small employer right before the retirement of a key employee whose defined benefit under the plan either approaches or matches the defined benefit plan limit in effect that year. However, this abuse is not present with respect to collectively-bargained plans; therefore, we would urge this Committee to exclude collectively bargained plans from this phase-in.

6. Apply Ten Percent Recapture Tax to Qualified Plan Assets Reverting to Employer - Chapter 14.05

ALPA supports a 10% recapture tax on the reversion of so-called "excess" assets to employers upon termination of a defined benefit plan. Such a penalty would have a deterrent effect on employers who are irresistably tempted to raid their "overfunded" pension plans.

ALPA has prepared a complete statement on the subject of the termination of defined benefit plans involving asset reversions, in connection with the Joint Hearing on this subject, held June 12, 1985 by the House Select Committee on Aging and the Subcommittee on Labor-Management Relations of the House Committee on Education and Labor. We would be happy to provide this statement to the Committee, if you would find it useful.

7. Revise Cash or Deferred Arrangements (Section 401(k)) and Employer Matching Contributions - Chapter 14.06

Under the proposal, a 401(k) plan is unavailable to tax-exempt organizations, on the apparent basis that Congress has not directly addressed whether tax-exempt organizations may maintain a "profit-sharing" plan. Rather than act by excluding tax-exempt organizations from maintaining this type of plan, hoowever, ALPA strongly urges this Committee to codify existing nonstatutory treatment permitting tax-exempt organizations to adopt such plans. The apparent inconsistency between the need to have "profits" to establish a profit-sharing plan and the requirement that tax-exempt organizations not operater for profit is, at most, a problem with semantics. Practically speaking, a tax-exempt organization is just as capable as a for-profit entity of determining whether the sum of its current income and reserves exceeds its expenses.

The proposal's suggestion that tax-exempt organizations do not need the availability of 401(k) plans in view of the proposed availability of unfunded deferred compensation plan is particularly confounding. To equate a qualified, funded plan with an unfunded, nonqualified plan is simply ridiculous.

Under the current law, an employee may defer up to 15% of his compensation under a 401(k) plan. In addition, the employee could defer up to $2,000 of his income annually in the form of an IRA contribution. The proposal would limit to $8,000 the amount which may be deferred annually under both the employer's 401(k) plan and his IRA.

ALPA does not believe it is prudent to place this burden on an individual to police a combined plan contribution limit with respect to his 401(k) plan and his IRA. In view of the burden associated with administering overall limits applicable to a combination of defined benefit and defined contribution plans, the proposal eliminated such overall limits for non-top-heavy plans. We do not see that an individual has any greater ability to administer a combined plan contribution limit than does an employer. Furthermore, it is not fair to include IRA contributions within the limit applicable to another tax-favored plan, since IRA's are presently available to all individuals who have compensation in a given tax year.

Finally, the proposal substitutes a new discrimination test for the ADP tests presently effective. ALPA urges this Committee to eliminate these complex tests, for collectively bargained plans, in view of the fact that such plans, by their nature, are not discriminatory. Our comments and recommendations set forth above with respect to the application to qualified plans generally, of a uniform nondiscrimination rule, apply equally with respect to the application of a similar rule to 401(k) plans.

8. Modify Rules For Benefit Forfeitures - Chapter 14.07

ALPA fully supports the proposal to permit forfeitures in a money purchase pension plan to be used to increase the benefits of the remaining participants in the plan.

B. FRINGE BENEFITS (Chapters 3.01 - 3.04)

1. Include in Income a Limited Amount of Employer-Provided Health Insurance - Chapter 3.01

Under current law, employer-paid health benefits and insurance premiums are excluded from employees' gross income. The President's proposal would require employees to include in their gross income these benefits and premiums, up to $10 per month, if the employee has only individual coverage, or up to $25 per month, if the employee has family coverage.

The includable amounts under the proposal are not large - up to $120 per year for employees with individual coverage and up to $300 per year for employees with family coverage. However, taxing health insurance can hardly be considered fair since it is the lowest levels of employer-provided health coverage which will experience the highest tax, when expressed as a percentage of the benefit subject to taxation. Furthermore, by taxing a non- cash benefit such as health insurance, employees will be forced to pay their taxes on the benefit not out of the amount paid as the benefit but out of their remaining cash compensation. The proposal states that the present exclusion discriminates against persons who, because they are not covered by employer-maintained plans, must purchase health insurance themselves, with after-tax dollars. However, this unfortunate fact is not a sound reason for denying the full exclusion to, in fact, discriminating against, the majority of the working public whose employers do provide some measure of health coverage.

Finally, once the idea of taxing even a modest level of health insurance takes root, it is only a matter of time before the level is increased. Such moves will likely lead to lesser health coverage of employees who, when given the option between taxable health insurance benefits and cash, will take the gamble in favor of cash. Ultimately, such decisions will thrust increased medical liabilities back on the federal, state and local governments, in the form of medical assistance to the poverty-stricken.

2. Repeal $5,000 Exclusion for Employer-Provided Death Benefits - Chapter 3.02

Under current law, the death benefits paid by an employer to the estate of adeceased employee are excluded from the recipient's income, up to $5,000. The proposal would repeal this very modest exclusion. ALPA urges this Committee to retain the $5,000 exclusion, in recognition of the simple fact that such benefits often represent the only means a survivor has to provide a decent burial for the deceased employee, without the additional burden of taxation on the burial benefit itself.

3. Establish a Uniform Nondiscrimination Rule - Chapter 3.04

ALPA agrees that the present system of taxing fringe benefits is confusing and disorganized in view of the variety of nondiscrimination rules applicable to such benefits. The proposed rule is identical to the rule proposed in Chapter 14.09 with respect to coverage requirements of qualified plans (i.e., percentage of the prohibited group benefiting under the plan must not exceed 125% of the percentage of the non-prohibited group benefiting under the plan.)

Our comments on the proposed nondiscrimination test for qualified plans set forth above in Paragraph (A)(1) of this statement, apply with equal force in the context of fringe benefits.

(C) Repeal Deduction of State and Local Taxes - Chapter 3.09

ALPA strongly opposes the proposed repeal of the itemized individual deduction for state and local income taxes. Such a drastic change in the federal tax law will have far-reaching implications. One result will be the waging of tax-cut wars between neighboring states, just as neighboring business competitors engage in price-cutting wars. Putting state against state speaks of catastrophic civil strife. Such tax-cutting would lead to the curtailment of vital government-provided services, such as education, and fire and police services. Furthermore, there would be a marked shift in the geographic disbursement of the citizens of this country in favor of those states with the lowest taxes and, necessarily, the flimsiest government services. The time bomb thus created would tick until its inevitable explosion.

ALPA does not believe that the federal revenues derived from the repeal of the state and local tax deduction can possibly be worth their price in terms of the massive social and political calamities which would surely result.

(D) Impose Current Taxation on Life Insurance Inside Build-Up - Chapter 10.06; Impose Current Taxation on Deferred Annuity Investment Income - Chapter 10.07

Under present law, the investment income earned on life insurance contracts and deferred annuity contracts purchased from life insurance companies escapes taxation until it is distributed. The proposal calls for the taxation of such investment income in the year it is earned. ALPA urges this Committee to retain the current tax treatment of such investment income, in furtherance of the long-standing policy against taxing individuals on amounts which although technically earned are not received. In addition, we believe it is wrong to impose current taxes on life insurance earnings since, to do so, will discourage the purchase of life insurance, leaving many survivors without adequate resources to maintain a decent standard of living. With respect to tax deferred annuities, we believe it is wrong to impose current taxes on people who are prudently planning for their retirement. Congress should foster, not hinder, the ability of people to provide for the economic security of their loved ones, in the event of their untimely deaths, and of themselves, in their retirement years.

CONCLUSION

ALPA thanks the Committee for the opportunity to present this statement. We stand prepared to provide whatever assistance you may require of us concerning the President's tax proposals.

EXHIBIT A*
Statement of Captain Henry A. Duffy, President
Air Line Pilots Association
July 31, 1985

Airline	Employees		Prohibited Group			Pilots As % of Prohibited Group	Non-Prohibited Group			Pilots As % of Non-Prohibited Group	% of Non-Prohibited Group Needed to Satisfy 125% Test
	Pilots	Total	Pilots	Other	Total		Pilots	Other	Total		
USAir	1,462	14,620	1,280	731	2,011	63.64	182	12,427	12,609	1.44	50.91
Alaska Airlines	183	1,830	148	92	240	61.66	35	1,555	1,590	2.20	49.33
Aloha Airlines	67	670	65	34	99	65.65	2	569	571	0.35	52.52
Air California	214	2,140	214	107	321	66.66	0	1,819	1,819	0.00	53.33
Delta	3,773	37,730	3,773	1,887	5,660	66.66	0	32,070	32,070	0.00	53.32
Eastern	3,475	34,750	3,050	1,738	4,788	63.70	425	29,537	29,962	1.41	50.96
Frontier	555	5,550	542	278	820	66.09	13	4,717	4,730	0.27	52.87
Flying Tiger	682	6,820	667	341	1,008	66.17	15	5,797	5,812	0.25	52.93
Hawaiian	120	1,200	48	60	108	44.44	72	1,020	1,092	6.59	35.55
Northwest	1,698	16,980	1,403	849	2,252	62.30	295	14,433	14,728	2.00	49.84
Ozark	433	4,330	401	217	618	64.88	32	3,680	3,712	0.86	51.90
Pan Am	1,627	16,270	1,556	814	2,370	65.65	71	13,829	13,900	0.51	52.52
Piedmont	919	9,190	912	460	1,372	66.47	7	7,811	7,818	0.08	53.17
PSA	456	4,560	420	228	648	64.81	36	3,876	3,912	0.92	51.85
Republic	1,616	16,160	1,612	808	2,420	66.61	4	13,736	13,740	0.02	53.28
Transamerica	116	1,160	112	58	170	65.88	4	986	990	0.40	52.70
TWA	2,791	27,910	2,791	1,396	4,187	66.65	0	23,723	23,723	0.00	53.32
United	4,934	49,340	4,736	2,467	7,203	65.75	198	41,939	42,137	0.46	52.60
Wien Air Alaska	156	1,560	86	78	164	52.43	70	1,326	1,396	5.01	41.95
Western	1,261	12,610	1,082	631	1,713	63.16	179	10,718	10,897	1.64	50.53

*The following assumptions were employed in the preparation of this Exhibit A:

(1) Pilot data relates to calendar year 1983.
(2) Pilots constitute 10% of an airline's workforce.
(3) In addition to pilots, 5% of an airline's workforce is within the proposed definition of "prohibited group."
(4) Pilots in the "prohibited group" are determined as those with annual compensation of $50,000 or more.

A

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C. P. Powell
Vice President
Taxes

AIR PRODUCTS

8 August 1985

Senate Finance Committee
219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Attn: John O. Colvin, Chief Counsel

RE: Transition Rules - Capital Recovery

Gentlemen:

If the present tax capital recovery system is modified, transition relief should be granted to taxpayers who have made commitments in reliance on current law. Many different factual patterns would exist. The purpose of this submission is to bring your attention to an area in which transition relief might otherwise be overlooked.

Long-Term Fixed-Price Contracts to Sell Product or Services

In some industries taxpayers enter into long-term contracts to build, operate, and sell substantially all output of a plant to one or a limited number of customers. An example would be pipeline supply of oxygen to a chemical manufacturer. Other taxpayers enter into contracts to perform a service which requires the construction of a processing facility. An example would be a contract with a municipality or a trash collector under which the taxpayer is to build a trash treatment plant and accept the trash for processing at a fixed fee.

Typically, these contracts extend over the life of the plant with the product or service price set, before construction commences, at an amount that is not subject to adjustment because of change in the income tax law.

A benefit from investment credit and ACRS is assumed in establishing the long-term price. If the benefit is not obtained, the supplier or service provider will be locked into a firm price that cannot be adjusted and a reduced return will result.

Senate Finance Committee
Page 2
8 August 1985

In the case of certain Air Products and Chemicals, Inc. contracts, it is estimated that under the President's proposals an increase in product price from 2% to 13% on production from new plants would be required to maintain existing profit margins. This assumes inflation is at a constant 5-6% rate and the corporate income tax rate is reduced to 33%.

General Transition Rules Not Sufficient

Often the long-term product or service price is set before significant direct cost is incurred and equipment orders are placed. Transition relief provisions framed in terms of the level of expenditure or commitments to an equipment supplier will not provide protection to the company that has entered into a contract to build a plant and supply product from a plant but has not yet progressed into the placement of equipment orders or the construction phase.

Avoidance of Retroactive Change Essential

The adoption of a new capital recovery system that does not provide transition relief and includes selective retroactive changes such as "windfall" recapture could have long-term adverse impact. It would signal taxpayers that they cannot rely on the continued availability of the capital recovery provisions including indexing in the tax law. This could have a very significant impact on decisions to invest.

Immediate Guidance Needed

The uncertainty created by the proposed modification of the capital recovery provisions is right now impacting the negotiation of ongoing contractual undertakings. The Congressional tax writing committees should act as soon as possible to indicate that transition rules will be available with some general statement of how they will be applied.

Very truly yours,

C. P. Powell
Cornelius P. Powell
Vice President, Taxes

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Statement of
Air Transport Association of America
Before the Finance Committee
U.S. Senate
On the President's Proposal for Tax Reform
September 10, 1985

The Air Transport Association is a trade and service organization of the U.S. airlines. The members of the Association account for more than 90 percent of the passenger miles and about 80 percent of the cargo ton miles flown by the U.S. airline industry. ATA airlines employ 325,000 people and operate 2,900 aircraft.

The Administration's tax proposals are of great interest to the airline industry because they affect the investment climate in which the industry operates. Airlines have enormous capital needs because their principal capital assets -- modern jet aircraft -- are so expensive, amounting to $60 million or more for a new transcontinental aircraft and related equipment.

Although it is one of the nation's most capital-intensive industries, the airline industry has not enjoyed financial returns adequate to its needs or commensurate with the earnings of U.S. industry as a whole. During the ten-year period 1974 through 1984, the U.S. airlines had a net profit margin of 1.2 percent. Return on equity was 4.2 percent, about one-third of the U.S. industry average of 13.3 percent. During the first half of the decade of the 1980's (1980-84), the airlines had a negative return on equity because of record financial losses.

After this period of heavy losses totaling more than $1 billion, the airlines had one of their best years in 1984, with an operating profit of nearly $2.2 billion and net profit of nearly $900 million on revenues of $43 billion.

Even in 1984, however, the net profit margin of 1.9 percent was far below the 4.5 percent attained by U.S. industry. The 8.9 percent return on equity in 1984 also lagged far behind the 13 percent return earned by U.S. industry as a whole.

Despite these inadequate financial results, the airlines found it necessary to invest more than $22 billion in new property and equipment in the 1980-84 period, mostly for new aircraft and spare parts to replace older equipment and provide for growth. The total investment in property and equipment reached approximately $40 billion at the end of 1984. The new aircraft make less noise, save fuel, and enable productivity gains that lessen transportation costs for passengers and shippers. The purchases were made possible by the availability of accelerated depreciation and the investment tax credit.

Airline Capital Requirements

The Association estimates that the airline industry in the next five years will need to invest nearly $50 billion -- more than double the investment of the past five years. This investment is necessary to replace the jet aircraft purchased in the early 70's and to respond to the growth in airline traffic. The Federal Aviation Administration forecasts that the number of airline passengers will increase to more than 430 million in 1989 from the record 1984 level of 343 million and this projection could be conservative.

To meet these needs, the airlines currently have 222 aircraft on order for delivery in the period 1986-91 costing an estimated $7.5 billion. These orders represent firm contracts with substantial progress payments having been made, and many of these aircraft were ordered more than three years ago.

Moreover, the airlines have options to buy an additional 300 aircraft with an estimated value of $12 billion. These options were included in the contracts for the aircraft on order. There is also a need for an estimated $30 billion of additional aircraft and other property over the next five years beyond that covered by the current orders and options.

As in many other major capital projects, aircraft are manufactured or constructed to order. Manufacturers do not maintain an inventory of aircraft available for off-the-shelf sale. Airlines determine their fleet plans and place orders for new aircraft as much as five years before delivery. When the order is placed, a deposit is made and additional progress payments are required during the period of construction. By the time of delivery, as much as 35% of the total price for the aircraft has been paid, with the balance due on delivery. The average price per aircraft on order is nearly $35 million.

The ability of the airlines to complete the purchase of the aircraft now on order, to convert the options into firm orders, and to place additional orders is contingent upon their ability to finance those purchases at a manageable cost and to realize a reasonable after-tax return on the new investment. It is clear that without the ability to finance the orders, many of the current options will not be converted into orders, and additional orders delayed or not placed at all. Such decisions would have an adverse impact on the aerospace industry and aircraft manufacturing jobs throughout the nation.

Airlines and Tax Reform

The airline industry has reviewed in detail the Administration's proposal for tax reform and has evaluated the impact of the sweeping change in the federal tax system which would result.

The airlines are concerned with a number of the proposed changes, but three are of major concern:

- Repeal of the Investment Tax Credit;
- Rate Reduction Recapture Rule;
- Alternative Corporate Minimum Tax.

These and other proposed tax changes will impact significantly on the ability of the airlines to finance future investments.

The proposed repeal of the Investment Tax Credit, when combined with the Rate Reduction Recapture Rule, will more than offset the benefit for many airlines of the proposed reduction in the corporate tax rate. The Alternative Corporate Minimum Tax of 20 percent, as proposed, will further increase the after-tax cost of the new aircraft.

Investment Tax Credit

The Investment Tax Credit (ITC) has been an important investment incentive since it was first enacted in 1962. The airlines believe that, with the current need in the U.S. for sustained capital investment, it is the wrong time to repeal this important aid to capital formation. In 1966-67 and 1969-71, when the ITC was suspended or repealed, business investment decreased significantly.

During 1983 and 1984 there was a robust increase in business investment, with a record 19.8 percent increase in 1984 alone. This increase occurred in spite of the high interest rates. Economists give a number of reasons for this investment expansion, including the investment tax incentives and the after-tax cash flow.

As was pointed out previously, the investment tax credit has been an integral part of the capital acquisition programs of the airlines since it was enacted. The ITC has provided the airlines with the additional financial ability to obtain the safest, most modern, and fuel efficient fleet of aircraft possible. The repeal of the ITC will put in question future orders for new aircraft. Without new orders, the aircraft manufacturers and their many contractors and sub-contractors will be faced with reduced work and/or layoffs.

Rate Reduction Recapture Rule

The Administration's proposal contains a unique provision which, if enacted, would adversely impact the airlines because of their significant investments in new equipment during the period 1980-85. This provision would require the airlines to include in taxable income in 1986, 1987 and 1988 a portion (12, 12 and 16 percent respectively) of excess depreciation taken through June 30, 1986, over 12-year straight-line depreciation.

The Association estimates that this proposal will increase taxable income for the airline industry by approximately $400 million each year in 1986 and 1987 and $530 million in 1988.

This provision, if enacted, would be a retroactive tax on the investments made over the past six years. It unjustly penalizes those companies and industries such as the airlines that, despite the high interest rates, have made investments during the recession, spurring growth in the economy. These are also the companies and industries that need to make the investments to provide jobs and growth over the next five years.

Alternative Corporate Minimum Tax

The Administration's proposal for tax reform also includes a 20 percent alternative minimum tax on corporations. While the airlines are not necessarily opposed to a minimum tax, they believe that the 20 percent minimum rate is excessive in a 33 percent maximum tax system.

Inclusion in the minimum tax of a preference equal to "25 percent of net interest expense" is unfair and harmful. The "25 percent of net interest expense" preference would be limited to the excess of the proposed Capital Cost Recovery System (CCRS) deduction over the amount allowed by Real Cost Recovery System (RCRS) as Treasury proposed in November 1984. This preference is unfair because it unduly penalizes highly leveraged companies even though new investment may be made with equity or internally generated funds.

The airline industry has traditionally been highly leveraged and that situation still exists. Because of the large amount of new inevestment over the last five years and the record losses in the early 1980's, the airlines were required to issue a significant amount of debt to finance the required investment. As a result, long term debt increased from $4.8 billion at the end of 1979 to $6.3 billion at 1984 year end. Debt as a percent of total capital rose from 53 percent to 57 percent during the same period.

The net interest preference is harmful because it creates a disincentive to new investment. A company with outstanding debt and new depreciable property would be forced to pay a tax on either a portion of its interest expense or the excess depreciation it takes. The only way to avoid this result is to forego investing in depreciable property. This would be very harmful to the economy, in general, and to capital intensive industries, such as airlines, in particular.

An alternative minimum tax with the "25 percent of net interest" preference is a particular problem for many airlines because of a large investment tax credit carryover balance at the end of 1985. We estimate that the unused 1985 ITC carryover will exceed $600 million. The minimum tax, combined with the net interest preference, will prevent most airlines from ever using the carryover ITC, thus denying them the very benefit the ITC was designed to achieve. Not only is this unfair, but it will also impair the ability of the airlines to order new aircraft and to finance the aircraft currently on order.

Summary

The Air Transport Association, on behalf of its member airlines, therefore urges that the Congress in enacting tax reform:

- Retain the investment tax credit to assist businesses, including the airlines, in making the capital investments to promote economic growth, productivity, jobs and a strong economy.
- Reject as a preference the proposed "25 percent of net interest expense" preference or any other substitute for depreciation deductions.
- Eliminate the proposed Rate Reduction Recapture Rule.
- Allow ITC carryovers to offset a portion of the minimum tax.

Other Provisions of the Administration's Proposal for Tax Reform That Are of Concern to the Airlines

- Proposal to Deny Tax Exempt Status for Bonds Used to Finance Airport Development

The Administration's proposal would subject bond issues of state and local governments to a new test to determine if they qualify for tax-exempt status. In essence, if a facility were used "more than one percent" by a non-governmental person, the financing of the facility would not be eligible for tax-exempt status. For air transportation, this test would effectively eliminate the primary means by which airport facilities are financed, and would seriously offset the ability of airport operators to meet the facility needs of the national air transportation system.

The FAA Administrator has stated on numerous occasions that the limiting factor in the future growth of aviation will be airport capacity. With the federal government now embarked on a $11 billion user-funded program to modernize the nation's airways system, recognition of the need to facilitate airport capacity development has increased. The prospect of elimination of tax-exempt airport financing would frustrate achievement of this goal.

In past years, when revisions to the tax laws affecting municipal finance have been considered, the Congress has consistently concluded that airports, as well as other transportation facilities owned and provided by state and local governments, serve a public purpose and should retain tax-exempt financing status. ATA urges the Congress to continue to classify as tax exempt all bonds issued to finance publicly-owned transportation facilities such as airports.

- Proposal to Repeal Section 861(e)

Presently, the income (or loss) from the lease of an aircraft to a U.S. airline by a U.S. lessor is considered U.S. income even if the aircraft is used in international flights. This provision is appropriate as U.S. airlines include all income from international operations in their U.S. taxable income. The effect of the repeal of Section 861(e) would be to require the U.S. lessor to exclude a portion of the lease income (or loss) from their U.S. source income and include it as foreign source income. While Treasury may assign a revenue gain from this proposal, the fact is that there will be none. Lessors will either prohibit the use of the leased aircraft in international operations or require the airline to pay additional rent to compensate for the loss of foreign tax credits by the lessor. Even if the latter result occurs, the higher income to lessors will be offset by the higher rental deduction of the lessee airlines. We urge that Section 861(e) be retained in the Code.

- Elimination of the Worldwide Limitation on Use of Foreign Tax Credits

The airlines are concerned about the proposed repeal of the worldwide limitation on the use of foreign tax credits. This action would then require a per country limitation on the use of such credits. In the case of airlines, this would cause the loss of many foreign tax credits. Under the U.S. model tax treaty which has been used in the vast majority of cases, income from the operation of aircraft in international transportation is taxed in the home country only. This reciprocal exemption was included in every treaty until the treaty entered into with the Philippines. The Philippine treaty allowed that government to levy a gross receipts tax on U.S. airlines doing business there and provides that such taxes would be creditable against U.S. income taxes. Since the Philippine gross receipts tax is imposed without regard to income or loss, only through use of the worldwide limitation can the credit be taken without significant country-by-country analysis. Such analyses were no longer required of international airlines once the world-wide limitation was enacted. Other countries not covered by a treaty impose taxes of the gross receipt type, and we understand that some of these countries may be seeking treaties with a gross receipts tax provision similar to that now contained in the Philippine Tax Treaty. The airlines continue to oppose gross receipts taxes and such treaty provisions. Clearly, extension of gross receipt provisions to other countries would create more problems. Therefore, the airlines urge the retention of the world-wide limitation in the Code.

- Proposed Employee Benefit Plan Change

The Administration's proposal contains several proposed changes to the present law regarding a number of employee benefit plans. Among these proposed changes are:

-- A uniform non-discrimination rule for the employer-provided benefits that is also incorporated in the retirement plan changes. This proposal includes changes in the definition of highly compensated and in the application of the tests for discrimination.

-- Changes in the deduction and benefit limitations for retirement plans.

-- An excise tax on early distributions from retirement plans.

-- Significant limitations on 401(k) plans.

The airline industry has provided a number of employee benefits including medical insurance and retirement plans to employees. Because of the differing nature of the work forces of individual airlines and their needs, these benefit programs differ. The industry is currently reviewing the impact of these changes and we will provide the Committee with the industry's views on these issues at a later time.

We appreciate the opportunity to provide comments on the Administration's tax reform proposal on behalf of our members. We will be happy to provide further comments if there are questions.

* * *

Statement By
American Apparel Manufacturers Association
before the Committee on Finance
U.S. Senate

October 4, 1985

The American Apparel Manufacturers Association supports enthusiastically corporate tax proposals put forward by the Administration. We strongly believe these proposals will improve the industry's international competitiveness. They also will encourage the retention of existing domestic jobs and stimulate the industrial growth likely to produce new ones.

The American apparel industry's impact on the domestic economy is substantial. Our industry consists of approximately 15,000 business which employ 1.2 million workers. This represents 6 percent of all domestic manufacturing labor. The annual payroll is more than $16 billion.

Apparel products are handled by an additional three million workers in the retail, transportation and service industries. Apparel factories consume 90 percent of all apparel fabrics manufactured by U.S. textile mills.

The American Apparel Manufacturers' Association, the AAMA, represents two-thirds of U.S. apparel production in all garment categories. Facilities are located in virtually every state. Membership is diverse in terms of size as well as geography. Most of the large companies in our industry are active in AAMA. However, nearly 86 percent of all members are relatively small companies with annual sales volumes below $20 million.

The apparel industry currently pays what we believe to be the highest effective tax rate of any major U.S. manufacturing industry. It averages approximately 39 percent. Many companies pay even higher rates. It has become increasingly difficult for the industry to compete and grow because we pay more than our fair share of taxes.

We are not asking for special treatment for our industry. Rather, our industry seeks fairness. We support the Administration's Corporate Tax Proposals because we strongly believe they will result in a fair and more efficient tax system in which:

- Business will be encouraged to grow.
- The effective tax rate of labor intensive industries such as ours will be closer to the 15-25% rates enjoyed by our major foreign competitors in Hong Kong, Taiwan and Korea.
- Companies with similar levels of income will pay comparable amounts of tax.
- Labor intensive industries will be able to compete fairly for funds needed to modernize and provide domestic jobs and
- All business will be better able to attract needed equity financing due to the reduction in the double taxation of corporate income.

Two features are central to the President's Corporate Tax Proposals. The first is a reduction in the tax rate for all businesses to 33 percent. The second is elimination of many of the special incentives that favor capital investment in general and certain industries in particular. People are the most important asset for industries like apparel which are labor intensive. Ironically in the face of persistent unemployment, the current tax structure discriminates in favor of capital intensive industries. We must eliminate this discrimination.

The apparel industry operates in a highly competitive and complex worldwide marketplace. The current tax structure puts the American apparel industry at a disadvantage in that marketplace. First, it makes it difficult to compete domestically for financial resources with lower taxed American industries. Second, it makes it difficult to compete internationally for a fair share of the marketplace with lower taxed foreign apparel manufacturers.

We also believe that investment decisions should be guided by the demands of the marketplace, not by tax considerations. Therefore, we oppose special tax incentives which distort the economy by encouraging business to base investment decisions on tax rather than economic considerations. The tax policy of favoring investment in machines rather than people should be ended.

Our industry is labor intensive. However, I want to emphasize that to remain competitive, apparel companies have invested significantly in the domestic economy by making major capital expenditures for new plants and equipment. Although many of our industry's expenditures resulted in tax benefits, they were mandated principally by the marketplace. Therefore, we do not believe the elimination of special tax incentives will affect future modernization decisions for the apparel industry.

A separate issue affecting American business is the double taxation of corporate income. As the Administration has noted, "The effective double taxation of dividends encourages corporations to finance their operations with debt rather than equity . . . [thereby increasing] the vulnerability of corporations to . . . cyclical changes in the economy." This is particularly important in an industry like apparel, which itself is highly cyclical in nature. We applaud the Administration's proposal to reduce the level of such double taxation.

Due to the magnitude of the President's Tax Proposals, there are provisions which unfavorably impact some members of the apparel industry. However, to achieve comprehensive tax reform, our industry is willing to accept the corporate tax changes in the form proposed by the President.

We are convinced that they will make the American apparel industry more competitive with foreign manufacturers and will encourage the retention and creation of domestic jobs.

Congress now has an historic opportunity for bipartisan reform of a corporate tax system that most will agree is neither fair nor efficient.

The proposed tax changes are necessary and achievable. The need for tax reform is urgent. The time is now.

We must not let the opportunity slip away. We are optimistic, Mr. Chairman, that with your leadership and the diligent efforts of the members and staff of this Committee, tax reform will be achieved.

STATEMENT OF THE AMERICAN ELECTRONICS ASSOCIATION
before the
Senate Finance Committee

October 2, 1985

AEA is the largest trade association of this nation's largest manufacturing industry. AEA represents over 2,500 high technology electronics manufacturers nationwide. AEA encompasses all segments of the electronics industries including manufacturers and suppliers of computers and peripherals, semiconductors and other components, defense systems and products, telecommunications equipment, instruments, software, research and office systems. The AEA membership includes companies of all sizes from "start-ups" to the largest companies in the industry, but the largest number (71%) are small companies employing fewer than 250 employees. Together, AEA member companies account for 63 percent of the worldwide sales of the U.S.-based electronics industries.

The U.S. tax provisions relating to the taxation of international activities of U.S. companies bear a close relationship to another major problem facing the U.S. today, which is receiving a great deal of attention form the U.S. government; namely, the current trade deficit and loss of manufacturing jobs to foreign competitors. This testimony will advance some general remarks about the underlying cause of the trade deficit and about policies the government can adopt to overcome the current deficit. Next these comments will focus specifically on how the international provisions of the tax law affect our trade competitiveness.

International Competitiveness and the Trade Deficit

The ability to compete internationally is essential to the survival of U.S.-based high technology industries. The combined effect of inordinately high expenditures on research and development and short product lives--between two and five years for most high technology products--means that high tech companies **must** sell to the widest possible marketplace to recoup their expenses as soon as possible. This worldwide competition benefits nut just high technology industries, but it provides for growth and job creation in the entire economy. A recent Department of Commerce report emphasized this point when it stated that "the United States will have to depend heavily on its areas of greatest strength--principally advanced technology--to meet increased competition in world markets."

For more than four decades the U.S. has been the leading proponent of the world's free-trade system. This has been especially true of the American electronics industry, which has flourished for the past twenty-five years. Yet today more and more Americans are questioning the validity of the free-trade philosophy. The growing trade deficit (a record $123 billion last year and expected to be $150 billion this year) and the loss of thousands of manufacturing jobs cannot be ignored. The cry of "fair as well as free" trade has become a chorus of voices from many quarters (including the Congress and recently the White House).

What has happened? Has our national prosperity made us complacent and less competitive? Has "Yankee ingenuity" disappeared? Or is something else going on? Have the rules of the trade game changed, and, if so, how should national policies be improved to reflect the new realities?

The strength of the dollar since 1980 has been the catalyst which has led to reduced competitiveness of U.S. companies in the world marketplace. It has made American manufactured products more expensive for foreign customers to purchase and it has made imported products less expensive for the American consumer. The national appetite for consumption, both in terms of individual consumption and the governmental dissavings (resulting from large federal budget deficits), have created a worldwide demand for dollars which has resulted in the appreciation in the value of the dollar vis-a-vis other currencies.

The well-recognized economic law of supply and demand dictates that the dollars which are in high demand will have a premium value. Interest rates for dollars have been driven to higher relative rates than for other currencies and the dollars invested are coming from offshore investors. In effect, the U.S. is borrowing dollars from offshore and then using the dollars to consume foreign products. In order to reduce the demand for dollars on a worldwide basis, the U.S. must reverse its individual and governmental pattern of consuming more than it saves.

It is also essential to note that the trade deficit is a national problem, and the solution can only be arrived at with the participation of our entire society. It is not merely a problem that affects or that can be solved by the business community. U.S. competitiveness is more than the ability of U.S. businesses to compete in the international marketplace (including the U.S. marketplace). It also directly affects the ability of the U.S. to continue to prosper and to provide its citizens with an increased standard of living.

U.S. Tax Policy Should Encourage Savings and Investment

U.S. tax policy, insofar as it favors consumption rather than savings, exacerbates this problem. The U.S. Tax Code encouraged the drift from a saving to a spending society. Mortgage and loan interest are tax deductable, while interest on savings and investment is taxable. A clear preference favoring real estate over securities investments has been establihed and persists to this day.

In the context of the President's tax reform proposal and other proposals being considered by Congress, there is concern that a significant shift of overall tax liability from the individual sector to the corporate sector would negatively affect our national savings rate. Such a shift of the tax burden to corporations, which have traditionally saved ten times more than individuals, would produce lower savings at the very time when larger savings are needed most.

The impact of tax laws and other government policies, including our seeming inability to meaningfully reduce the federal budget deficit, have a great deal to do with our national inability to save rather than consume, and, consequently, of our ability to reduce the worldwide demand for dollars. While American companies strive to become more competitive and productive, these efforts are negated by the difficulty of competing in the international marketplace when, during the last five years there has been approximately a 50 percent increase in the value of the dollar.

Tax Policy Directly Affects U.S. Competitiveness

With respect to tax reform, we must understand how very closely tax policy is tied to international competitiveness. Our tax system discourages saving and encourages borrowing. It also results in a high effective tax rate for that sector of our economy most affected by competition from abroad: manufacturing. In short, the process of evolving from a savings to a consumption society has increased to the cost of capital for U.S. business.

Capital formation and its prudent use determine productivity growth, and ultimately, the standard of living of our citizens. The productivity rate is directly linked to savings. If you take our six major trading partners and rank them from top to bottom on capital formation, that listing will almost exactly mirror the ranking in productivity growth. You will find Japan at the top of both lists, the United States at the bottom.

The goal of U.S. tax policy should be to mitigate or reverse the trade deficit problem, its causes and its effects. We believe that many of the international tax "reform" proposals being considered by Congress will not successfully mitigate this problem and, in fact may reduce U.S. competitiveness further. Such a result must not be produced by inadvertance. The price for the relatively small revenue gains of the following international provisions of the President's proposals (and staff options of the Ways & Means Committee) will be significant interference with the competitiveness of U.S. business, and the U.S. itselef.

Per-country Foreign Tax Credit Limitation

The President's tax reform proposals recommend changing the long-established overall foreign tax credit limitation to a per-country limitation. AEA is encouraged that the House Ways and Means Committee staff options paper rejects the President's recommendation. We suspect that the following reasons were instrumental in leading to such a decision.

The President's plan suggests that the per-country limitation is justified on the basis that the reduction in corporate tax rates as applied to foreign income will not be offset by the base-broadening provisions affecting some types of domestic income. While it may be true that some sectors of the business community would receive a net tax cut on foreign income under the President's proposal, many electronics companies would generally bear increased taxes.

For example, Treasury Department estimates may not reflect current economic realities, such as the dramatic increase in the value of the dollar since 1980. Even if some companies were to benefit from a reduced tax rate with respect to foreign income it would not necessarily be inappropriate, since there are also a number of types of domestic income that will benefit from rate reductions but not be adversely affected by the base-broadening measures.

Lower U.S. tax rates will not change the fact that foreign jurisdictions will continue to tax the foreign earnings of U.S. companies, in many instances at higher rates. The underlying principle of the foreign tax credit is the relief of double taxation. Congress has repeatedly considered whether the overall or per-country limitation better accomplishes this objective. The implications of lower rates do not alter the fundamental judgment made by the Congress that the U.S. is best served by the overall foreign tax credit limitation which recognizes that the activities of U.S. taxpayers outside the United States are generally interrelated.

Concerns about investment decisions made solely to enable taxpayers to fully utilize all foreign credits have not been supported by anything more than general statements and assertions about what taxpayers might do. Changing from the overall limitation to a per-country limitation on such speculative grounds, without further study of the possible responses of U.S. taxpayers to the per-country limitation, would be inappropriate and detrimental to the basic purpose of the credit. The substantial opposition by taxpayers to the per-country limitation (and the other proposed foreign provisions) is clearly inconsistent with Treasury's analysis that the effect of the changes will be a rate reduction on foreign income.

The President's tax plan indicates that a per-country limitation is justified by the need to counteract the investment bias that would result from the reduction of the maximum U.S. corporate tax rate. This argument assumes that U.S. companies will in fact shift their investment resources from the U.S. to lower tax jurisdictions in response to lower corporate rates. If this logic were pursued, the lowering of U.S. tax rates should result in fewer operations moving offshore.

If, as alleged by the Treasury Department, U.S. tax considerations are the most critical factor regarding the decision of U.S. companies to locate operations outside the United States, then one could more readily accept Treasury's recommendations. However, for major U.S. companies, tax considerations, particularly excess foreign tax credits, are only one relatively minor factor in decisions to locate manufacturing operations.

Such a sweeping change in the foreign tax credit rules that will affect the mainstream activities of most U.S. multinationals should not be enacted based on behavior which will the the exception rather than the rule. In the past, to the extent abuses have arisen with respect to certain types of investments (i.e., investments in interest-bearing obligations), they have been specifically addressed by modifications within the context of the existing overall foreign tax credit limitation.

Assuming that taxes are one of several factors on which companies base investment decisions, the proposed per-country limitation would create a new incentive to generate low-taxed income within a country to offset high-taxed foreign income within that same country and also to shift foreign investments to low tax jurisdictions to avoid excess credits. The overall limitation, on the other hand, allows companies to concentrate on other more important factors involving investment decisions. Futhermore, a per-country limitation would also make it more expensive for U.S. companies to repatriate foreign earnings from certain countries and thus would discourage companies from reinvesting those proceeds in the U.S.

The per-country approach would create very serious administrative

and compliance difficulties for both taxpayers and tax enforcement officials. The complexity, uncertainty, and costs associated with the proposed per-country limitation will inhibit the ability of U.S. companies to operate internationally and could undermine the ability of the U.S. to effectively administer its tax system.

Many foreign sales involve scores of transactions occurring in many different countries. The more products a company sells, the greater the difficulty for both the company and the government in accounting for each transaction on each product in each country. It is important not to lose sight of the fact that the existing overall limitation, with its special exceptional rules for certain types of income, has been relatively easy to administer and has provided U.S. companies with a much-needed degree of certainty with respect to their foreign investments.

Almost all countries have a mechanism that treats foreign earnings at least as favorably as the U.S. under the overall method. **In fact, many countries impose no tax at all on foreign earnings.** U.S. companies that must compete in worldwide markets should not be burdened by the imposition of the per-country limitation and its relatively greater cost and compliance requirements.

Given the seriousness of this issue, there does not appear to have been a commensurate degree of study on the effects of the proposed change on the ability of U.S. companies to compete internationally. The proposed per-country limitation raises many unanswered questions concerning its effect on U.S. competitiveness and on the ability of the U.S. to administer its tax laws. Because of those concerns and the general effectiveness of the current system, we believe that the overall method is the preferable method for calculating the foreign tax credit limitation.

Source of Income Rules

The President's proposals as well as those of the Ways and Means Committee staff options provide new rules for sourcing income. In particular, exports of products from the United States would generate only U.S. source income, rather than, as under current law, export income that is 50 percent foreign and 50 percent U.S. source. Sales to foreign affiliates and subsidiaries would produce 100 percent U.S. source income under the proposal. Exports to countries where the U.S. exporter has no affiliates could be treated as 100 percent foreign source only if the exporter has a fixed place of business outside the U.S. which participates "materially" in the sale.

These proposals alter well-established tax principles for determining source of income. The existing rule provides a fixed standard for dividing the profits from export sales between U.S. and foreign source income. Moreover, **this rule, in practice, applies only to exports, thereby encouraging exports and maintaining the competitiveness of U.S. companies. If this rule were changed, it will potentially increase the tax costs of export business** (due to reduced use of foreign tax credits) and reduce the ability to compete cost-effectively. In turn, this could reduce the quantity of exports or stimulate further offshore manufacturing and increase the already high trade deficit.

There is no fundamental reason why this solution is preferable to the current rule. The exception allowed under the proposal for sales income attributable to a foreign, fixed place of business turns on whether the fixed place of business "participated materially" in the sale. This standard substitutes a costly and administratively difficult transaction-by-transaction, facts-and-circumstances determination for a clear, workable rule. The rule also encourages the establishment by U.S. companies of offshore business facilities; a policy which is exactly the opposite of what the U.S. needs.

Furthermore, the proposed rule on "fixed place of business" treats differently those U.S. exporters selling to foreign customers through a subsidiary and those selling through a branch. There is no policy reason why identical foreign income-generating activities should produce disparate results, based on whether the foreign sales are made through branches or foreign subsidiaries. Based on the circumstances of each particular case, including the level of activity in each entity, foreign tax rate, level of income taxed by the foreign jurisdiction, etc, the disparity will vary. In any case, the fundamental point is that the 50/50 split between U.S. and foreign source income under Section 863(b) of current law provides an arbitrary **but workable and predictable standard which avoids overly detailed, complex, and difficult-to-audit standards.**

Research and Development Expense Moratorium

Neither the President's proposal nor the Ways and Means Committee's staff options include an extension of the moratorium on the allocation of research and development (R&D) expenses to foreign income for purposes of Treasury Regulations Section 1.861-8. Without further action, the moratorium will expire at the end of 1985. Without an extension of the R&D expense moratorium, there would be a disincentive for continuing increased R&D activities in the U.S. because the required allocation of a portion of such R&D expenses to foreign source income thereby reduces the foreign tax credit limitation. This disincentive would occur at the same time that **other countries have enacted R&D incentives (i.e., Japan, France, and Canada).**

The R&D expense moratorium must be considered in the context of the movement of manufacturing jobs offshore. Once manufacturing jobs have moved offshore, the natural progression is for other related jobs to follow. Thus, the likely result is the loss of R&D jobs following the loss of the related manufacturing jobs.

This event not only means a threat to employment growth in the U.S. but a longer term threat to our competitiveness through increased foreign based R&D activities aimed at our market. It is consequently imperative that the U.S. mitigate this result with a tax policy encouring to the maximum degree the performance of R&D activities in the U.S. rather than offshore. Failure to extend the R&D expense moratorium is contrary to this policy goal. The benefit of performing R&D activities in the U.S. would be reduced rather than maximized if the moratorium were to expire. If the U.S. believes that it is important for R&D activities to be encouraged in the U.S., then the same U.S. R&D activities should also be favorably treated for purposes of the extension of the R&D expense moratorium.

Conclusion

We believe that a proposed per-country foreign tax credit limitation, proposed changes in the sourcing of manufacturing export sales income, and the failure to extend the research and development expense moratorium are not sound U.S. policy because these provisions would worsen our already serious trade imbalance.

Finally we should note that such proposed changes to foreign tax provisions would generate relatively small revenue gains. If Congress is interested in raising revenues in an effort to broaden the tax base without threatening investment and productivity, we suggest shifting the emphasis of our tax system to consumption rather than investment.

We urge the Congress seriously to consider international tax provisions not just as U.S. tax policy but instead as an integral and important part of U.S. trade policy, and to judge the soundness of proposed changes only in the appropriate larger context of U.S. international competitiveness. Such an analysis, we believe, must lead inevitably to rejection of the proposed per-country limitation and foreign source rules, and an extension of the R&D expense moratorium.

WRITTEN STATEMENT
OF THE AMERICAN PETROLEUM INSTITUTE
BEFORE
UNITED STATES SENATE COMMITTEE ON FINANCE

Regarding

IMPACT OF THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY ON THE FOREIGN TAX PROVISIONS

Washington, D. C.
October 2, 1985

Foreign Tax Credit

To avoid international double taxation of income, the United States allows U.S. taxpayers to credit foreign income taxes paid on foreign source income. The amount of credit which may be claimed is subject to an "overall" limitation under I.R.C. Sec. 904(a). In effect, a taxpayer is allowed to average foreign tax rates above and below the U.S. rate; but this in no way permits use of foreign tax credits to reduce U.S. income taxes on income earned in the United States.

The Administration proposals for changes in international taxation are purportedly made in order to "rationalize and improve existing law." However, for the most part, these proposals have been considered and rejected by both Democratic and Republican administrations over the last 20 years. For the reasons discussed later, it is API's conclusion that these proposals would make U.S. companies less competitive in international markets which can only adversely affect U.S. trade.

In the General Explanation of the Proposals, the Treasury contends that the averaging of foreign tax rates permitted through the overall limitation is undesirable for at least two reasons. First, it is asserted that averaging "causes economic decisions to be distorted purely for tax advantage." Second, it is claimed that "the overall limitation permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investments."

Contrary to the first statement, the decision to invest abroad is principally driven not by U.S. tax considerations, but by business considerations such as access to foreign markets, transportation costs, work force, location of existing facilities, and government requirements. And, of course, in the case of foreign exploration in the oil industry, the crucial factor is the likelihood of finding oil, not the existence of excess foreign tax credits in other countries. The allegation in the General Explanation is purely conjectural and cites no evidence that current U.S. tax law causes U.S. multinationals to distort investment decisions.

The Treasury's second complaint implies an objective of influencing foreign countries to reduce their local tax rates to levels which the U.S. Treasury deems suitable for American purposes. That would be an inappropriate step towards extraterritorial applications of U.S. tax law in foreign sovereign states. We are confident that the attempt would be both unsuccessful and deeply resented by our trading partners.

The Treasury's solution for these perceived problems is the introduction of a so-called "per country" limitation, under which the amount of credits available to offset U.S. taxes on foreign source income would be limited on a country by country basis. Current "baskets" of income under Code Sec. 907(a) and Code Sec. 904(d) would, in general, be retained. A special country loss allocation rule is suggested under which a net loss in a given country would be prorated against income from all other countries, including the United States. When income is subsequently earned in the loss country, the income would be "resourced" (or "recaptured") to the country or countries to which the loss was assigned. The proposal would extend the current five year carryforward period for excess credits to ten years, but it would not lengthen the present highly restrictive two-year carryback period. The proposal would be effective for taxable years beginning on or after January 1, 1986. However, no carrybacks to pre-effective date years would be allowed.

U.S. taxation of foreign source income of petroleum companies has been the subject of close scrutiny by the Congress for the past 10 years. This review has produced several significant modifications of the tax rules for U.S. petroleum companies which have eliminated so-called "deferral" of U.S. tax on numerous categories of foreign income and severely limited the amount of foreign taxes which are creditable. Under the present U.S. tax rules (subpart F), generally the foreign oil related income of a petroleum company is not entitled to any "deferral" unless it is earned in the country where the oil or gas is produced or consumed. Moreover, while foreign oil and gas production income is subject to significant foreign taxes in virtually all countries where production takes place, the amount of allowable foreign tax credits is restricted by statute and regulations which impose special limitations and administrative barriers that are not applied to other industries.

The petroleum industry pays a high effective rate of tax on its worldwide income. (See the Joint Committee Study for the period 1980-83.) The enactment of the proposed per country limitation would significantly reduce the amount of foreign taxes which the petroleum industry could credit against U.S. tax liability on foreign source income. This increase in the total tax burden on foreign petroleum activities would act as a disincentive to the further search for oil and gas abroad by U.S companies.

Under present law, U.S. companies are competitively disadvantaged in low-tax countries vis-a-vis local competitors or foreign multinationals unless the American companies also operate in high-tax countries abroad. Then, they can average high and low taxes and, accordingly, may be able to compete with local companies or foreign multinationals whose home countries either exclude foreign source income from tax or effectively allow an overall limitation. To the extent that U.S. tax would be imposed in excess of the local rate as the result of abandoning the overall method, all U.S. corporations would be disadvantaged in low-tax countries vis-a-vis their foreign competitors.

Even if the tax in the foreign country is equal to or greater than the U.S. tax over the life of a project, there can be years when the foreign tax is temporarily lower because of differences in the timing of capital cost allowances permitted in U.S. and foreign law. Under the per country method, U.S. tax would be collected in those early years. With only a two-year carryback, little of this tax could be recouped; and even with an infinite carryback, interest would be lost. Since foreign-owned competitors of American companies do not bear this burden of having to pay home country taxes in the early years, the per country method would impose a competitive disadvantage on American firms in these circumstances. This can be a particularly serious problem in the petroleum industry.

The proposal to repeal the overall limitation would represent a reversal of tax policy that has prevailed for 24 years during which the overall limitation has been either mandatory or available to taxpayers as an election. When Congress decided in 1975 (and 1976) to eliminate one of the two alternative limitations, it came to a conclusion exactly the opposite of this proposal and decided to retain the overall limitation. In view of the credit's history, Congress was well aware of the relative advantages and disadvantages of each of the two approaches.

One effect of the overall limitation is to permit averaging of taxes paid in high-tax countries with those in low-tax countries, which the Administration now finds so objectionable. This averaging effect is completely consistent with the approach normally taken by U.S. business in making investments abroad -- to serve geographic markets which may involve integrated production, transportation, and marketing facilities in several different countries. In 1975, the House Ways and Means Committee established a Task Force on Foreign Source Income (chaired by Rep. Dan Rostenkowski). This aspect of the overall limitation was addressed in its Report dated March 8, 1977 (p. 35) as follows:

> In many instances this averaging of foreign taxes would appear to be appropriate. Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.

The Rostenkowski Task Force cited another reason for preferring the overall limitation (also on p. 35 of the Report) as follows:

> An equally important consideration in comparing the overall limitation by itself with a combination of the per country and overall limitations is the relative burden which each approach places on taxpayers and the IRS. The per country limitation requires that a separate computation be made for each country in which a taxpayer operates. Each of these computations requires the taxpayer to calculate the gross income and deductions to be allowed to each country. Since, as discussed above, many large corporations operate on an

> integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in a difficult position of attempting (upon audit) to review a company's operations in every country around the world. These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group.

The proposed loss recapture rules similarly introduce unnecessary complexity to our foreign tax credit system. In addition, the proposed loss recapture rules, by combining an overall concept for spreading losses with a per country limitation on profits, distort the results that would be achieved under a true per country limitation. While there are both advantages and disadvantages to the use of either the overall or the per country limitation, the proposal selectively adopts the disadvantages of each of the limitations while eliminating most of the advantages.

The treatment of losses under the proposal also results in unequal treatment between domestic losses and foreign losses. With a rate reduction to 33 percent, a loss on a domestic project would provide a current U.S. tax benefit worth 33 percent of the loss. Under the proposal, a net foreign loss allocated to income from another foreign country employing a tax rate equal to or in excess of the U.S. tax rate of 33 percent would provide no current tax benefit to the U.S. taxpayer.

In sum, API believes:

(1) U.S. oil companies operating abroad would be put at a competitive disadvantage vis-a-vis their foreign competitors.

(2) The proposed loss allocation rule would result in unequal tax treatment between domestic losses and foreign losses and would thus discriminate against foreign investment.

(3) The averaging of foreign taxes accomplished through the overall limitation is an appropriate recognition of the realities of integrated international business conduct.

(4) The per country limitation is unnecessarily complex. The President's proposal acknowledges this complexity. The overall limitation method greatly alleviates administrative and enforcement problems occasioned by the per country method.

The present rules for international taxation are so complex that taxpayers cannot now plan their international activities with any degree of certainty as to the U.S. tax result. The Administration proposals would further complicate this area of the law leaving both taxpayers and the I.R.S. with even more uncertainty than now exists. The overall foreign tax credit limitation should be retained so that U.S. companies can remain competitive in the ever increasingly difficult search for energy resources in the world.

Allocation of Interest Expense

In the case of a consolidated group of corporations, existing rules require that the allocation of interest expense between domestic and foreign sources be made separately for each member of the group. The Proposals would change the treatment of allocating a company's interest expense from a separate company to a consolidated group basis.

The General Explanation, in describing the basic principles that should be applied in formulating rules for determining the source of income, states:

> [T]he rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries.

The interest allocation proposal completely violates this principle. The United States would not permit a foreign corporation doing business in the United States to receive a tax benefit for interest paid by a related company even if the foreign country required an allocation for its own tax purposes just as no foreign country would allow a deduction if the situation were reversed. Any unilateral modification of sourcing rules should be confined to situations where local effect can be given to the allocation, e.g. through tax treaties. Otherwise, a competitive penalty is imposed on international business conducted by U.S. corporations.

Under the proposal, interest expense incurred by a corporation doing business exclusively in the United States would be allocated in part to foreign source income if another member of its consolidated return group happened to do business overseas. The proposal is very anti-competitive as regards the after-tax cost of financing U.S. investments. For example, domestic

Corporation A (wholly owned by U.S. shareholders) which has no foreign operations, would receive a full U.S. tax deduction for its interest expense. Each dollar of interest would cost the company 67 cents after tax [$1.00 - .33 tax = $.67]. Its U.S. competitor (also wholly owned by U.S. shareholders) which did half its business overseas and was taxed at a rate in excess of the U.S. rate, might borrow to finance an identical investment in the United States. Each dollar of its interest expense, however, would cost it 83 cents after tax [$1.00 - (.33 X .50 tax) = $.83]. This anti-competitive result is neither fair nor productive of economic growth.

Under the proposal, existing foreign projects which were financed with debt instruments that have been repaid would be subject to the allocation of group interest expense. The result could be that the group's foreign tax credit would have been reduced twice for the same overseas project: (1) initially, under the original debt funding the foreign project; and (2) by the allocation of group interest expense.

Debt structures of large corporations which have evolved over the years frequently include numerous intercompany loans. A corporation may borrow from third parties with the proceeds being loaned and reloaned several times within the consolidated group. Under the Proposals, the interest paid by each corporation would be aggregated for allocation purposes, thereby overstating the actual interest paid. This result cannot be supported.

The proposal would reverse the policy adopted by Treasury in the consolidated return regulations of 1966 and reaffirmed in 1972 (Rev. Rul. 72-281, 1972-1 C.B. 285) and in the sourcing rules of 1977, i.e. that each member of a group remains a separate legal entity and should be treated as such. In the absence of any evidence whatsoever that the existing rule of 20 years standing is not working, no change is justified. Abuses of the rule, should any appear, can be dealt with selectively under existing legal principles without disadvantaging some U.S. companies vis-a-vis their competitors.

Vast amounts of capital have been deployed through business decisions based in part upon current law. Borrowings which are done by individual members of a group for valid business purposes, e.g. to limit liability, to maintain credit ratings of other members of the group, to share liability with a joint venturer, etc., have business and financial significance and should be respected for tax purposes as well. Equity dictates that borrowing made by members of a group of corporations based on their own creditworthiness should be treated on a separate basis. The current allocation of interest expense on a separate company basis should be retained.

216/09

STATEMENT
OF THE
AMERICAN RENTAL ASSOCIATION
ON
TAX REFORM

The American Rental Association ("ARA") is a national trade association, comprised of over 4,000 independent member firms engaged in the business of renting diverse items of equipment and other personal property to the public. Our national office is located in the ARA Building at 1900 19th Street, Moline, Illinois 61265. ARA is in its 30th year of operation, and is the sole organization representing the industry of equipment rentals on a national basis.

ARA member firms rent a very wide variety of equipment and personal property, including such lines as homeowner items; party supplies and equipment; construction machinery and equipment; vehicles and other mobile equipment; medical equipment and devices; and exercise and recreational equipment.

In 1976, the United States Department of Commerce estimated the equipment rental industry to include 10,000 equipment rental outlets in the United States.1/ That number

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1/ See Equipment Leasing and Rental Industries: Trade and Prospects, U.S. Department of Commerce, December 1976.

is considerably greater in 1985. These firms are primarily small business firms and tax reform, whether in the form of the President's proposal or any of the various plans that have been offered in Congress, will vitally affect our industry as well as others.

ARA commends the efforts being made to redesign the basic structure of our tax system to promote simplicity and fairness. There is little disagreement that there is a great need for revision of the complex, cumbersome and often illogical federal tax code. The ongoing debate is not whether tax reform is needed, but rather is on what should comprise its various components. The ultimate simplicity and equality of a flat tax is probably not achievable at this time so it behooves each of us to offer and aggressively pursue respective recommendations and positions in the legislative process that will find the common good for the people and the country.

We wish to address only two proposals currently being considered which are of enormous concern to the equipment rental industry, i.e., repeal of the **Investment Tax Credit (ITC)** and a change in the method of depreciation from an Accelerated Cost Recovery System (ACRS) to a **Capital Cost Recovery System (CCRS)**.

These changes would contradict the proinvestment policy underlying the Economic Tax Recovery Act of 1981 (ERTA) and drastically curtail the tax incentives inherent in depreciation and ITC. The proposed changes would have a widespread, adverse impact not only upon equipment industry firms, but moreoever upon all small businesses and the business community in general. In fact, these two areas of tax policy are of such major import to our industry that they may affect the very survivability of many individual firms.

Several proposals advanced to reduce capital cost recovery allowances for equipment, such as Kemp-Kasten, Roth-Moore, and others, would not substantially increase and would sometimes reduce the cost of capital. But as the following Table I shows, the Administration's proposed CCRS would substantially **raise the cost of capital for investment.** Increased capital costs will reduce investment, and the economy will stagnate as it did before the ERTA was enacted.

Table I
Cost of Capital Under
Various Recovery Methods

Recovery Method	% Change in Cost of Capital Compared to Current Law*
ACRS-ITC 3 Year (Present Law)	--
ACRS-ITC 5 Year (Present Law)	--
ACRS 18 Year (Present Law)	--
NCRS 4 Year (Kemp-Kasten)	+ 1
NCRS 6 Year (Kemp-Kasten)	+ 2
NCRS 25 Year (Kemp-Kasten)	-23
SCRS 6 Year (Bradley-Gephardt	+ 5
SCRS 18 Year (Bradley-Gephardt)	+16
SCRS 40 Year (Bradley-Gephardt)	- 9
RCRS 5 Year (Treasury)	+ 2
RCRS 17 Year (Treasury)	+ 9
RCRS 63 Year (Treasury)	-12
CCRS 4 Year (Reagan)	+ 1
CCRS 7 Year (Reagan)	+ 6
CCRS 28 Year (Reagan)	-12
EXPENSING	--

*These numbers utilize Treasury's assumptions of 5 percent inflation and a 4 percent real discount rate.

Because of the obvious equipment-intensive nature of the equipment rental industry, ITC is of paramount concern to our member firms. Rental equipment is, quite literally, our "stock-in-trade". Characteristic of and peculiar to the rental industry is the rapid depreciation of equipment from the wear and tear that results from the same item being rented many times over to the renting public and the frequent need for periodic replacement of inventory. Reinvestment in inventory is calculated on the assumption of a five-year turnover of equipment.

A further disincentive to business investment would be the unprecedented "recapture" tax on "excess depreciation" in the Administration's proposal. The effect of this tax would be to tax income from investments made between 1980 and 1985 at the higher 46% rate whereas income earned from investments made after 1985 would be taxed merely at the lower 33% rate. This sudden recapture tax would create dire cash flow problems for those businesses which have made capital investments in recent years in justifiable reliance on existing federal tax law. This retroactive change in the "rules" would create a "cash crunch" and leave little or nothing available for new investment and equipment. Small equipment rental firms would be particularly disadvantaged.

It has been argued that the reduction in the maximum corporate tax rate to 33% would reduce tax revenue by about 180 billion over the next five years but this does not even come close to offsetting the portion of the $260 billion in increased taxes on capital that would fall on the corporate sector.

Further, no consideration has been given to losses due to repeal of capital gains treatment for depreciable property. If reform embraces the concept of windfall gains, it should also embrace compensation for windfall losses generated by other provisions in the reform proposal.

The combination of the ITC and the ACRS was the cornerstone of the capital formation policy of the Economic Recovery Tax Act of 1981. This policy recognized the importance of fixed assets to the national economy and allowed businesses to make the needed investment in plant and equipment which helped fuel the spectacular economic recovery.

The combination of the ITC and the ACRS, which together is almost the equivalent to expensing on a present value basis, (i) successfully reduced the tax bias against investment, (ii) resulted in the highest rate of capital formation in any post-war recovery period and, (iii) enabled the federal government to collect an additional $33.5 billion dollars in tax revenue.

Tax reform must be pro-economic growth. Repeal now of the ITC, a change in the current method of depreciation (ACRS) and imposition of a burdensome recapture tax will have a chilling effect on business investments and lower, not higher, revenues will be the result. Productivity will suffer and the rate of economic growth will decline.

The Congress has before it an opportunity to design a tax reform plan that promotes capital formation, fosters continued economic growth and increases productivity.

The American Rental Association strongly urges the Congress to retain the present and proven **Accelerated Cost Recovery System** and the **Investment Tax Credit** and to not impose a recapture tax on prior deductions taken under the depreciation systems that were then in effect.

STATEMENT OF THE
ASSOCIATION OF AMERICAN RAILROADS
BEFORE THE
COMMITTEE ON FINANCE
U.S. SENATE
ON
THE PROPOSALS FOR TAX REFORM

October 18, 1985

The Association of American Railroads, with headquarters in Washington, D.C., represents the nation's freight railroads. The railroads which are members of the Association operate 92 percent of the line-haul mileage, employ 94 percent of the workers and account for 97 percent of the freight revenues of all railroads in the United States.

We appreciate the opportunity to offer these comments presenting the views of the railroad industry on the Treasury II proposal and the recent option prepared by the Joint Committee on Taxation for consideration by the Ways and Means Committee. As a highly capital intensive industry, we are obviously concerned over the capital recovery aspects of these proposals.

Our industry joins virtually all industries in telling you that we support the stated goals of tax reform -- fairness, growth and simplicity. While we appreciate the political necessity of reasonable compromise in reaching these goals, the proposals before you clearly place an unduly heavy burden on capital intensive industries of which the railroad industry is one of the major elements. We urge the Committee to preserve a favorable climate for productive capital investments. In light of the unemployment in the nation's capital-intensive industries, their generally inadequate financial posture, and the growing pressures they face in international markets, the nation cannot afford a tax system that creates substantial disincentives for capital formation.

Last year the railroad industry had revenues of $29.5 billion, employed over 303,000 people, and made capital expenditures of $4.3 billion. We also incurred approximately $3.3 billion in taxes to Federal, State and local governments -- the equivalent 122 percent of our $2.7 billion in net income.

As we view these proposals, they will cause a drastic decline in the cash flow of all railroads. In the first five years under the Treasury II proposal, we calculate a loss of over $2 billion -- the vast majority of which will be telescoped into the first three years. For a typical major rail company, the five year losses will approximate over $330 million. Under the Joint Committee's option, those five-year losses double -- over $4 billion for the industry and $660 million for a major railroad. And those losses assume our customers do not suffer. In truth, many of our major users will be similarly affected. If the domestic automobile, steel, chemical, and mining industries are forced to reduce their levels of production, our traffic levels will decline and in the long run our ability to serve them will be impaired. So in effect, we will suffer at least a double whammy -- the inevitable prospect of lower profits and higher taxes.

Tax reform is a laudable goal, but it cannot be considered in a vacuum. If, because of tax reform, our basic industries are stripped of their ability to compete in the market-place, then the economy in general and the railroads in particular would lose more than they will gain from the reform movement, even if it were neutral to the railroads. To redistribute the corporate tax burden from one sector of the economy to another doesn't make much sense if the result is to do serious damage to much of industrial America.

Ours is a large nation, with more than 100 million people holding down full-time jobs. Our country cannot exist solely as a service or a high tech economy. Instead, we must be a broad-based economy that can more or less do it all, particularly from the standpoint of national security. If not, we are going to create massive unemployment problems and cause great social and economic upheavals that could have very serious political implications.

The Treasury II Proposal - An Analysis

General

The proposal calls for higher overall corporate taxes to help pay for rate reductions for individuals. Within the corporate sector, the tax increase aspects of the plan are focused disproportionately on the capital intensive sector. Companies in basic and heavy industries, through changes in the capital cost recovery system, would pay considerably more in taxes over the next five years than under the current system. The beneficial provisions of the plan, such as lower corporate tax rates, do not come close to offsetting this serious blow to America's industry. According to initial Treasury estimates, corporations will pay an additional $120 billion in taxes. However, capital intensive industries will contribute more than 100 percent of this amount, while service industries would pay less than their current levels.

ACRS/ITC

The proposal repeals both the investment credit (ITC) and the Accelerated Cost Recovery System (ACRS) and substitutes a new depreciation system (Capital Cost Recovery System - CCRS). These proposals will promote neither economic growth nor employment in the United States.

CCRS is less generous than the combination of ACRS/ITC which yield approximately the present value equivalent of expensing for capital investments -- its purpose when enacted by Congress. Although more favorable than the Treasury I original depreciation plan (RCRS), the Treasury II proposal moves capital investment away from the parity with labor and services that should be maintained.

On a present value basis, the new depreciation plan may, depending on the property category and the discount rate, approximate the current capital recovery system in the long run. However, initially the proposed CCRS depreciation substitute will be negative.

In any event when the loss of the ITC is added into the equation, capital intensive industries are clearly major losers. And as internal cash flow in the corporate sector falls, the pressure on borrowing and interest rates must rise.

It is argued that these losses from abandoning ACRS and ITC will be offset by the benefits in the proposal, most predominantly the lower corporate tax rates. The benefit of the rate reduction is dependent on the ratio of a company's earnings to its capital expenditures. As this ratio increases, so does the benefit of the rate reduction. However, the railroad industry and other major capital intensive industries have historically had a low ratio of earnings to capital expenditures, as evidenced by their extremely low rates of return. Consequently, the rate reduction is far less beneficial to the railroad industry than it is to non-capital intensive companies. If the proposal stopped there, the objections -- at least within the railroad industry -- would be constrained. But it does not!

Recapture Tax

The most devastating aspect of Treasury II is the recapture tax -- a provision which requires taxpayers to include in income over a three-year period 40 percent of accelerated depreciation claimed between January 1, 1980 and July 1, 1986 on assets placed in service during 1980 through 1985. This is tantamount to a retroactive change in Federal tax law as it nullifies benefits of ACRS for property placed in service during 1981 through 1985 and ADR depreciation for property placed in service in 1980. The rationale for including assets placed in service in 1980 is unclear since their cost was not recovered under ACRS.

This recapture provision is particularly punitive to capital intensive industries. Many companies invested in plant and equipment as a result of ACRS which was enacted in the Economic Recovery Tax Act of 1981. It is unjust to penalize these companies that stimulated the economy when they were encouraged to do so by the 1981 Act.

This provision is the major reason why a disproportionate share of the revenue-raising burden in the proposal is borne by capital intensive industries during the first three years. Railroads, in particular, would be most severely affected due to their large amount of track-related expenditures -- a goal encouraged by the Federal government for the past two decades.

As the Committee is aware, under the 1981 Act, railroads were required to depreciate expenditures for track replacements installed during 1981 through 1984 over a recovery period which ranged from one year in 1981 to four years in 1984. Prior to the 1981 Act, railroads were entitled to deduct the entire cost of track replacements in the year the expense was incurred, using the retirement-replacement-betterment (RRB) method of accounting.

When the 1981 Act was in its formative stages, Treasury was insistent on having all taxpayers, including railroads, adopt ACRS. Consequently, the railroads were required to abandon the RRB method and adopt ACRS beginning in 1981. To mitigate the potentially severe impact of an abrupt change from a one-year write-off of track replacements to recovering the cost over a five-year period, Treasury agreed to phase-in ACRS for track replacements over a five-year period. This depreciation recapture provision retroactively cancels the benefits of this transitional rule and the railroad industry's understanding with Treasury. As a result, the excess depreciation of railroads will be greater than that of taxpayers in other industries having the same amount of capital expenditures.

The reason given for this recapture is to prevent taxpayers from obtaining an unexpected windfall which would result from the proposed reduction in the corporate tax rate from 46 to 33 percent. This provision presupposes that depreciation deductions claimed prior to 1986 received a 46 percent tax benefit at the time the asset was purchased, and that future income generated by the asset will be taxed at only 33 percent. However, the truth of the matter is that many companies, mainly because the ITC and operating loss carry forwards lowered their rates well below 46 percent, received a much smaller benefit. Since the windfall never fully occurred, the tax functions as a penalty rather than as a windfall recapture. Such a penalty tax should not be an element of true tax reform.

In addition, the recapture occurs in the first three years -- a far shorter period than if capital intensive industries had calculated their depreciation on a straight line basis. In other words, by moving up the windfall recapture, more money is calculated than if the benefits never occurred.

Finally, the tax hurts the same companies that are most adversely affected by other provisions of the Treasury II plan -- the capital intensive companies in basic industries.

Why was depreciation selected as the only target for the revenue-raising penalty tax? Rate reduction will always bring with it certain "windfalls". Shareholders of corporations that pay less under the proposal will experience a windfall increase in the value of their stock. Noteholders who set interest rates on long-term loans anticipating a 46 percent tax rate will receive unexpected benefits. So will corporations that are recovering greater cash as a result of research credits and other tax incentives built by the Congress.

Business needs certainty to make sound investment decisions. Retroactive taxes unnecessarily complicate the investment process, make long-term investments even riskier and cause taxpayers to lose faith in government. It is noteworthy, that the academic and economic experts assembled at the recent Ways and Means Committee's retreat were unanimous in their opposition to this retroactive provision.

The Joint Committee Option -- An Initial Reaction

On September 26, 1985, the Joint Committee on Taxation released its Summary of Tax Reform Option for Consideration by the Committee on Ways and Means. The railroad industry's initial analysis of this proposal indicates that the devastating losses estimated under the Treasury II proposal would be at a minimum doubled. This Joint Committee proposal is ill-conceived and would result in irreparable harm to the nation as a whole. In an attempt to provide a quick-fix to the highly criticized portions of the Treasury II proposal and to remain "revenue neutral", this proposal has simply ignored many of the stated tax-reform goals.

The capital recovery provisions of this proposal are so inadequate that they seriously threaten the viability of the nation's basic industries. By eliminating ITC and more than doubling the recovery period for most assets, the proposal will increase the cost of many capital replacements beyond the point of affordability. The result will be an accelerated crumbling of the nation's industrial infrastructure. In regressing from the Treasury II proposal, this proposal extends the recovery period of railroad assets from seven to 11 years and eliminates indexation of depreciation. Over a five-year period, this change more than offsets the cost of recapture in the Treasury II proposal, and in the longer term never permits the full recovery of railroad capital costs. In addition, railroads are put in the precarious position of having track temporarily assigned to Class 4 property until the Treasury performs a study of its ADR midpoint.

The benefit from the rate change, which even under the Treasury II proposal did not offset its capital recovery cost, is diminished as well. As feared, the maximum rate has moved its way upward from 33 to 35 percent and many believe that this is only a first step. In addition, the minimum corporate tax rate has increased to 25 percent which is precariously close to the maximum 35 percent rate. Our fear is that capital intensive industries such as railroads could, by simply making required capital investments, get caught in a continuing minimum-tax spiral.

Beyond these devastating effects, the proposal eliminates the preferential tax rate for capital gains and initially reduces the dividends paid deduction to almost an imperceptible level.

To provide some idea of the degree of harm this proposal would generate over a longer term, we compared it to the cost of the Treasury II proposal for 11 years. We estimate that this proposal would cost the railroad industry an unconscionable $9 billion dollars over 11 years, assuming we could survive that long. It is clearly a case of a bad idea gone astray.

Impact on the Railroad Industry

These proposals result in a redistribution of the tax burden from individuals to corporations and within the corporate sector from service and high-tech industries to capital intensive companies. And the railroad industry, which is very capital intensive, would bear a significant portion of this redistribution.

The lost cash flow to our industry resulting from the proposals is staggering. Over the five year period 1986-1990, we would suffer a cash flow loss of $2 to $4 billion. Among major railroads, the loss would average approximately $330 to $660 million per railroad, even if their business levels remained the same, a gossamer hope at best.

Such reductions will produce lower capital investments which mean lost jobs. Reduced orders of capital goods on our part and other similarly situated industries as a result of the cash loss attributed to this tax program has to affect employment adversely in those domestic industries which produce such goods, e.g., steel, aluminum, autos, etc.

The proposed depreciation methods coupled with the repeal of the investment tax credit represent another major setback for capital formation. Since 1980, our after-tax cost of investing in new track has steadily increased, primarily due to changes in tax policy. Prior to 1981, under the RRB accounting method, a one dollar investment in replacement track cost the typical railroad 50¢. In 1981, with the enactment of ERTA, our after-tax cost of a one dollar investment in track increased to 56¢. In 1982, after the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, which required taxpayers to reduce depreciable basis or investment tax credit, our after-tax cost of a one dollar investment in track increased to 58¢. Under the Treasury II proposal, the after-tax cost of a one dollar investment in track will rise to 74¢. And finally under the Joint Committee's proposal it increases to 79¢. (These amounts were all computed for 1986 using a discount rate of 10 percent and assuming an annual inflation rate of 5 percent.)

The proposals must also be reviewed in the context of its impact on our customers. Our level of employment and capital expenditures depends upon the health of our customers. If the proposals cause manufacturing companies to move offshore or if the new cost recovery provisions impede U.S. industry's ability to compete, resulting in reduced demand, our industry will be hurt. For example, autos and auto parts, chemical, minerals, ores, and coal are of particular importance to the railroads. Together they constitute half of our freight revenues. Each of these industries is likely to suffer under the Treasury II proposal because of the higher cost to produce their goods. It is inevitable that if capital investment is penalized, not only will our key customers do less business, but so will the railroad industry and its suppliers.

Impact on Nation

The proposals are fraught with risk and uncertainties from our nation's perspective. Among the potential results are less investment, lower productivity, fewer jobs, smaller GNP, greater budget deficits, larger trade deficits, and higher interest rates.

For example, the increase in the cost of capital equipment in the U.S. will further impair the ability of U.S. companies to expand and modernize plants and equipment, continue to diminish the international competitiveness of U.S. companies and workers, and increase the vulnerability of U.S. production and jobs to imports. Moreover, the combined effect of increasing the tax cost of U.S. manufacturing while decreasing the tax on sales of goods in the U.S. market, and the more favorable cost recovery systems which exist in other industrialized nations, would actually provide an incentive for U.S. companies to manufacture goods abroad for sale back into the U.S. The results would be a substantially increased trade deficit and a significant loss of jobs. The commonly used rule of thumb is that for every loss of $1 billion in investment, there is a corresponding loss of 50,000 jobs. Thus, for example, a $30 billion loss in investment in the capital-intensive sector implies a loss of 1.5 million in jobs.

If ACRS and ITC were to be jettisoned in favor of either the CCRS or Joint Committee's depreciation systems, the U.S. would rank near last or dead last, respectively in the industrialized world in cumulative cost recovery deductions allowed for most equipment through the first three years that the equipment is in service.1/ This surely would cause the U.S. to be less competitive

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1/ This is based upon a study by Arthur Anderson and Co., which compared the cost recovery deductions of the U.S. with those of 15 industrialized countries.

with its principal international competitors in terms of cumulative cost recovery deductions allowed in the critical early years following the time the equipment is placed in service.

Proponents of this proposal tell us that jobs lost in manufacturing will tend to be absorbed in the service sector of the economy in the long run. However, the transition, if it ever occurs, necessarily will be slow and painful. Moreover, this shift in the composition of employment would be very costly to the economy. Wages in the service sector, on average, are considerably lower than in manufacturing. A substitution of service jobs for manufacturing jobs will result in a lower average wage level for the economy as a whole. In addition, the transition will create "structural" unemployment, which is costly in terms of lost income, tax revenues, and outlays for unemployment compensation.

Arguments to the effect that cost recovery allowances should be reduced because so-called basic industries do not pay taxes or that they have drastically lower so-called "effective tax rates" should be examined very carefully and, in my view, be rejected.[2]

In the railroad industry, for example, the effective tax rates during the 1980-1984 period were relatively low. The basic reasons for those low rates are straight forward. First, having earned less than two percent on its investment before interest payments for over a decade, many carriers had huge loss carry forwards. Second, the recession in this period caused a severe decline in profits. Third and last, the Treasury's changes in depreciation for track investments, made solely at its urging, increased deductions in the 1981-1985 period. All of these phenomena have now passed for most railroads and we are facing effective tax rates well above the average experienced by U.S. industries, providing our profit trend continues, even if no tax changes are made.

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[2] A recent study concludes that overall marginal effective rates do not differ between the basic industry and high tech sectors. In any event, differences in such rates, to the extent they may arise, are not caused by the tax treatment of depreciable assets. See Don Fullerton and Andrew B. Lyon, Does The Tax System Favor Investment in High Tech or Smoke-Stack Industries?, Working Paper No. 1600, Natural Bureau of Economic Research, Inc., April 1985.

Conclusion

One need only to look to the recent past to see the importance of an appropriate investment climate. In 1981, our country was experiencing severe economic problems. During the decade of the 1970's and the early 1980's, the United States had one of the lowest rates of productivity growth, capital formation and savings of any of the major industrialized nations. The serious decline in productivity growth resulted in the concurrent loss of our ability to compete with other nations.

In 1981, through the Economic Recovery Tax Act (ERTA), Congress demonstrated its awareness of the importance of a tax system that would produce a favorable climate for capital investment. The cost recovery provisions of ERTA (ACRS/ITC) provided a much needed cash flow injection for business, which reduced the need to borrow and thus helped decrease interest rate pressures.

Our statistics on productivity have also shown a remarkable improvement. While the United States ranked last in 1979 (compared with its major trading partners), it is now second only to Canada in productivity. One of the primary factors in the improved productivity has been the modernization of plant and equipment. In 1983, for the first time in a decade, the U.S. edged out Japan in the race for the world's most modern facilities.

ACRS/ITC has worked. It has been recognized that business fixed investment has been a major factor in the economic recovery. Over the past two years, real capital expenditures increased at a 15 percent annual rate, a record by all historical standards. And during the earlier recession, the combination of these provisions prevented a more serious decline in business capital outlays than might have been expected.

To step back now from the advance made in capital recovery in ERTA is to regress to a pattern of capital formation and job creation worse than that which existed in the 1970's. Such a regression, especially in the name of fairness, growth, and simplicity is painfully ironic to the railroad industry. We believe, in order for the tax reform benefits to be borne equitably by all sectors of the taxpaying public -- individuals, service/hi-tech industries, and capital intensive businesses, that any change in the federal income tax system should take into consideration the total tax burden of business from all taxing authorities. Railroads already bear a heavier burden than the average company in terms of employment taxes. Railroad retirement taxes are three times higher than the Social Security (FICA) taxes paid by non-railroad employers. Railroads also have a heavier property tax burden than most companies. To focus strictly on a company's federal income tax liability simply is not representative of the entire picture. With respect to simplicity, we believe that for corporations these proposals would clearly increase the cost of complying with the tax law. And this burden, too, would fall heaviest on capital intensive companies. We are convinced that the proposals would reduce our capital spending and increase unemployment. We hope that your Committee plans to move cautiously in dealing with the tax reform proposals which could have some very damaging effects on our industry, the economy, and our nation's long-term prosperity.

We suggest that if your Committee finds it necessary to advance any of the current tax reform proposals, it should modify the Treasury II proposal by phasing in the rate reductions for individuals and corporations, by gradually phasing out the investment tax credit, and by eliminating the depreciation recapture provision. We also believe that other forms of taxation should be examined, such as a consumption or value added tax, in conjunction with the overall issue of tax reform. Finally, additional reductions in federal spending are essential.

STATEMENT OF

EDWARD J. SCHLEGEL
EXECUTIVE VICE PRESIDENT

CATERPILLAR TRACTOR CO.

ON

PRESIDENT REAGAN'S TAX REFORM PROPOSALS

U.S. SENATE
COMMITTEE ON FINANCE

OCTOBER 2, 1985

I appreciate the opportunity to submit this statement which discusses Caterpillar's views of President Reagan's tax reform proposals and the implications for international competitiveness.

Before getting into specifics of the tax plan, I'd like to bring you up-to-date on events at Caterpillar. Our company, as some of you know, is a leading manufacturer of earthmoving, construction and materials handling machinery and equipment; and engines. We're a major American exporter whose principal manufacturing base always has been in the United States. Over the past five years we have exported $12.5 billion worth of product. Last year nearly 40 percent of our U.S. activity was dependent on exports. Our exports provided jobs for some 16,000 people.

But frankly, over the past three years, Caterpillar has been struggling. An extraordinarily overpriced U.S. dollar which has given a major edge, both overseas and increasingly at home, to our foreign competitors, is a principal reason. On a trade-weighted basis, the U.S. dollar, adjusted for inflation, has appreciated 50 percent vis-a-vis Europe and Japan since the first half of 1981, thereby adversely affecting U.S. manufacturers' competitiveness.

Though the dollar problem is well beyond our control, we're responding decisively to the adverse business environment. We've implemented a major cost-cutting program. You all know as well as I that budget cutting isn't easy. But, by the end of this year, our costs, adjusted for inflation and volume, will be 22 percent less than they were in 1981.

To get costs down, and to help offset the effects of the strong dollar, we've reduced employment, closed and downsized plants, and changed production and supplier sources in some cases to overseas locations.

In short, we're doing the things necessary for Caterpillar to continue to be the industry leader worldwide.

We don't believe it should be -- or is -- the conscious intent of policymakers to throw additional hurdles before American businesses which have made significant strides in responding to the challenge of foreign competition. Unfortunately, the President's tax plan does that.

It does not account for the fact that some businesses face tougher foreign competition than others. Nor does it consider that some industries, like ours, operate on far lower margins than others. In 1981, our most recent profitable year, Caterpillar's pretax margin was just over 8.5 percent. That compares with considerably higher margins in many companies. Lower-margin manufacturers requiring significant amounts of capital investment can least afford a significant additional burden, but stand to be among the hardest hit by the President's tax plan.

We have estimated the President's proposal could increase our company's tax burden by nearly $70 million next year and more than $300 million cumulatively over the next five years. Let me put that in perspective. An increase of this magnitude in next year's tax burden would more than offset the savings we expect to receive in 1986 as a result of our downsizing efforts.

Caterpillar jobs depending on U.S. exports would be especially hard hit by the tax reform proposal. Employment will be reduced, and of the remaining jobs, a greater portion will have to be located outside the United States -- or our company just won't be competitive.

One of the tax plan's most direct, adverse effects on exports would come from provisions affecting the Foreign Tax Credit. For Caterpillar, the tax plan would have nearly the same effect as repeal of the Credit. Two presidential recommendations concern us. One proposes to change the source rules relating to sales income. The second proposes a switch from the current "overall" limitation to a "per country" limitation. For our company, both proposals must be removed from the tax plan in order for an effective Foreign Tax Credit to be maintained.

The Credit helps provide substantial opportunities for many U.S. exports which otherwise would be lost to non-U.S. competition. In 1984, Caterpillar's foreign manufacturing subsidiaries and affiliates purchased nearly a quarter of a billion dollars worth of U.S.-manufactured components and other production material from the parent company. It's also been our experience that foreign investment -- by giving us market access and greater acceptance with non-U.S. customers -- can increase our sales throughout our entire product line, including that which is U.S.- rather than foreign-sourced.

Excessive taxation from the proposed Foreign Tax Credit revisions would, in effect, increase the cost of U.S. exports resulting from foreign operations. At a time of record trade deficits, tax reform should be moving in the opposite direction.

We are concerned about the tax plan's treatment of capital formation incentives. If we are to maintain a significant U.S. manufacturing presence and compete successfully around the world -- including right here in the United States -- Caterpillar must have "high tech" facilities. Right now, we're planning hundreds of millions of dollars of expenditures to build the most technologically advanced plants in our industry. But let me be blunt: if such an investment can't be made to pay off, it won't be made here; and the ultimate effect will be to move more jobs overseas. A key element in making such massive U.S. investments economically attractive is retention of the Investment Tax Credit and Accelerated Cost Recovery System.

Caterpillar's U.S. modernization activities and sales would be further hampered by the depreciation "recapture" proposal because the government would absorb funds which otherwise could go to new investments. These provisions would penalize those who responded positively to an effective investment stimulant.

The President's proposals affecting capital formation would have a double negative impact on a company like Caterpillar because not only do we buy capital equipment but we also sell it.

That's a brief overview of our concerns. Attached to my statement is additional information, including our analysis of the proposed Foreign Tax Credit revisions; a statement addressing the Investment Tax Credit and Accelerated Cost Recovery System; and an overview of the President's plan in general.

Obviously, some of our concern is parochial. But even more we're concerned about the dramatic impact that these proposals I've mentioned would have on the ability of U.S. companies to compete from a U.S. base.

Ultimately, my company — Caterpillar — will regain its competitiveness. But the strength of the dollar already has forced a lot of Caterpillar purchasing and manufacturing activity offshore. Enactment of the tax proposals I've mentioned will speed up that process.

We simply don't think that it's good national policy to force companies like Caterpillar — capital intensive, U.S.-based manufacturers — to set up shop abroad. That's too high a price to pay for "tax reform".

Thank you.

CATERPILLAR TRACTOR CO.

Peoria, Illinois 61629

The Foreign Tax Credit Debate: Source Rule for Sales Income

Present law generally results in the source of sales income being recognized as the place where the income is actually earned -- normally where ownership of the goods passes from the seller to the buyer. If a company has manufacturing operations, an appropriate portion of the income is also attributed to the place of manufacture.

The Treasury proposal would provide that sales income would have as its source the country of the taxpayer's residence.

* * *

Treasury's arguments in support of the revised source rule for sales income:

1. "Low-taxed foreign income . . . may be generated by using the existing source rules simply to shift income to low-tax jurisdictions. For example, income from certain sales may be sourced in any country by having the title pass there."

2. The proposed changes in source rules "reflect more closely the economic substance of the transaction."

3. "In combination with the reduced rate of corporate tax, the proposed changes in the foreign tax credit limitation and source rules will result in a substantial net reduction in the U.S. tax on foreign income. In effect, the combination will make the foreign tax credit operate more efficiently and equitably without penalizing foreign investment."

Caterpillar rebuttal of Treasury arguments regarding revision of sales income source rule:

1. There are safeguards against arranging ownership passage (which entails more than title passage and is the determinant of the place of sale under current law) purely for tax benefit.

   Contractual agreement dictates where ownership will pass. The seller cannot dictate the terms for his own tax benefit. Caterpillar Americas Co. (CACo.), a U.S.-based wholly-owned marketing subsidiary of Caterpillar Tractor Co. (CTCo.), sells product to non-U.S. customers mainly in the Western Hemisphere. Because of the locations of its customers, the passage of ownership associated with most CACo. sales occurs upon arrival at the port of entry in the customer's home country (not some "artifical" low tax country). CACo. bears ownership carrying costs, insurance charges, and the risks of loss during shipment.

   Treasury already is empowered to address abuses arising from pro forma application of title passage, by looking to the substantive realities of the transaction.

2. Treasury's "place of residence" would not "reflect more closely the economic substance of the transaction." Assume CACo. buys a Caterpillar track-type tractor manufactured in Brazil, and sells it to a customer in Mexico. Under present law, this sales income would be foreign-sourced.

   But under the Treasury proposal, the income would be considered earned in the United States even though the tractor never entered the United States, and the employees who promoted the sale were in Mexico.

3. For Caterpillar, passage of either the change to a country-by-country limitation or the change in rules regarding source of income would have about the same effect as repeal of the FTC. (Foreign taxes paid still would be allowed as a deduction.) Result would be a combined effective tax rate of over 100 percent on some Caterpillar foreign-sourced earnings. There would be a significant net increase in U.S. taxation of the company's foreign source income.

The Foreign Tax Credit Debate: Per-Country Limitation

Under present law, the amount of foreign income taxes that may be claimed as a credit is subject to an "overall" limitation. All foreign taxes and foreign income are aggregated to determine the allowable tax credit. A U.S. taxpayer may apply limitation generated in one foreign country to obtain credit for taxes generated in another. In effect, there is an "averaging."

Treasury proposes replacing the overall limitation with a per-country limitation. Under the per-country method, a separate limitation is calculated for each foreign country.

* * *

Treasury's arguments in support of per-country limitation:

1. The current overall limitation "distorts investment decisions. A taxpayer has an incentive to generate low-taxed foreign income to utilize excess foreign tax credits. As a consequence, investments may be shifted from the United States to low tax countries . . . . The proposed reduction in the U.S. corporate tax rate will greatly increase excess foreign tax credits. This will correspondingly increase the incentives to divert investment and income to low-tax countries, if the overall limitation is left intact."

2. "There are those who will argue that the Treasury Department proposal will only aggravate the problem of excess foreign tax credits. But this defense of the overall limit on the credit is based on a misunderstanding of the purpose of the credit. The purpose of the credit is to avoid double taxation of foreign source income. The per-country limit achieves that. Relief from taxes in excess of U.S. taxes on the same income must be sought elsewhere."

3. "A 'per-country' limitation is used by most other countries that allow a foreign tax credit, and it was long used in the United States, either with the overall limitation or alone."

Caterpillar rebuttal of Treasury arguments regarding country-by-country limitation:

1. For companies like Caterpillar, it simply is not true that the overall limitation, with or without a lower tax rate, results in investment diversions to low-tax countries. As a recent editorial in the Journal of Commerce pointed out: "The idea that companies site their plants, refineries, etc. in low tax countries for the tax break just doesn't wash. Well-managed companies select foreign sites for substantial business reasons: labor costs, political stability, access to markets or raw materials." In fact, the foreign investment Caterpillar has made to compete successfully in some markets has been in relatively "high tax" countries. If an American firm is barred from exporting to a market by a prohibitive tariff or other barrier, or otherwise cannot compete successfully by shipping from the United States; and if American tax policy makes it impossible to compete by investing in that market country; then there is no incentive for investment anywhere.

2. Double taxation -- and an aggravation of the problem of excess foreign tax credits -- under the per-country limitation is inevitable. The U.S. determines FTC limitation by computing net foreign source income (gross income less deductions pursuant to IRC861). But the U.S. has negotiated tax treaties permitting (even encouraging) foreign withholding taxes on gross income (income before considering IRC861 expenses). This discrepancy can cause inequities even under the overall limitation, but that limitation system mitigates the harm because foreign tax credits generated in one country may be taken against limitation generated in another country (one in which, perhaps, little if any foreign taxes must be paid). In some cases the foreign, treaty permitted, withholding tax (on gross income) alone may well exceed 100 percent of the net income determined after applying IRC861.

3. Most other countries employing a "per country" limitation also provide for significant levels of exemption of foreign source income; it is only the remaining amounts of non-exempt foreign source income which might be subject to this credit limitation.

   The per-country limitation was previously required in the U.S. before, but this was before effective implementation of IRC861 (which results in the use of net income in calculations to determine allowable FTC). Both limitation and most foreign withholding taxes were generally computed on gross income. So many of the inequities which would arise today under the per-country limit did not result.

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FIVE INVALID ARGUMENTS AGAINST THE INVESTMENT TAX CREDIT AND ACCELERATED COST RECOVERY SYSTEM

The economic impact of repealing the investment tax credit (ITC) or Accelerated Cost Recovery System (ACRS) would be especially burdensome for capital equipment manufacturers like Caterpillar. The company's tax burden would rise (while our foreign competitors' burden remained relatively unaffected), and there would be a reduction in the demand for Caterpillar products.

Following are five arguments frequently voiced against the ITC and ACRS, and Caterpillar's views on them.

1. "The corporate income tax burden has declined dramatically, so repeal of the investment tax credit (ITC) and Accelerated Cost Recovery System (ACRS) is justified."

Caterpillar Position: Corporate income taxes as a share of total U.S. budget receipts have declined. Part of the reason has been tax law changes designed to support capital formation and other beneficial economic activities. There are at least two additional good reasons:

-- Corporate profits haven't risen as much as personal income; and

-- U.S. budgetary reliance on social insurance taxes and contributions has increased dramatically. These payments accounted for less than 16 percent of total budget receipts in 1960 and over 36 percent in 1984. In effect, they have allowed less reliance on the corporate income tax. This isn't all "good news" for corporations; business pays roughly half of the total payroll taxes -- a much greater percentage than its share of income tax payments.

2. "The 1981 corporate tax changes simply went too far; a 'correction' is needed."

Caterpillar Position: This argument presumes that the goal of depreciation provisions should be to match depreciable lives with assets' actual useful lives. Often this simply isn't possible. Caterpillar products used in highway construction, for example, may have a significantly different useful life than the same products working at a demolition site.

More important, the main objective of the ITC and ACRS is to stimulate capital investment. This broader public policy goal has been achieved. The combined incentive resulting from the ITC and ACRS is a key reason capital investment during the recent economic recovery was stronger than during past recoveries, even though past recoveries saw interest rates and capacity utilization more conducive to investment. Comparisons with other countries tell a similar story. Canada, whose economy closely matches that of the United States, has a higher savings rate, but has not experienced the investment surge that has occurred in this country.

(over)

3. "Repeal of ITC and ACRS is needed to help create a 'level playing field' for the different types of businesses investing in the United States."

Caterpillar Position: The "playing field" U.S. tax policy affects does not stop at the nation's borders. Consideration of what constitutes sound policy must not stop there either. According to the National Association of Manufacturers, "Until the enactment of ACRS in 1981, American companies had to use a depreciation system much inferior to what was available in most other industrialized countries. Returning to that situation will only impair the ability of capital intensive American firms to compete in world markets, further worsening our already disastrous trade balance."

The Business Roundtable has indicated that "The adoption of ACRS in conjunction with the investment tax credit substantially narrowed the gap" between the costs of capital investment in Japan and in the United States.

Last year, over 60 percent of Caterpillar's sales outside the United States were of U.S.-manufactured product. To compete successfully, Caterpillar must have "high tech" U.S. facilities. Keeping the company's U.S. plants modern requires ongoing capital expenditure (which totaled $161 million in 1984).

Repealing the ITC or ACRS would hinder American exporters' U.S. modernization programs. The deterioration of U.S. competitiveness, which already has resulted in the loss of at least 2 million U.S. jobs, would worsen.

4. "The ITC and ACRS lead to investments for tax benefit rather than economic productivity."

Caterpillar Position: Abuse of tax incentives should be dealt with. But policy decisions must be based on facts, not misconceptions. The existence of city blocks of empty office buildings often is cited as an example of investments made solely for tax benefit. But the investment tax credit does not apply to buildings; and ACRS benefits for real estate were curtailed last year. According to one study, 90 percent of the incremental investment resulting from ACRS and the ITC has been in equipment. For Caterpillar, the tax incentives support investment vital to the well-being of the company and its employees.

5. "The net impact of the overall Treasury plan, of which repeal of the ITC and scaling back of depreciation provisions is a crucial part, would help the U.S. economy."

Caterpillar Position: The alleged economic gains of the Treasury proposal are unproven. The argument that lower marginal rates will help the economy by leading to increased savings is being disputed. Individual income tax rates were cut in 1981, but the U.S. personal savings rate dropped. It's been estimated that ACRS provides $.81 of business fixed investment for each dollar of "lost" tax revenue. The ITC provides $.76, but a rate cut only $.19. Caterpillar believes it would be an unwise gamble to sacrifice proven, targeted incentives like the investment tax credit for the unproven, untargeted benefits of lower marginal rates.

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THE FOREIGN TAX CREDIT: PROPOSED REVISIONS

Unlike many industrialized countries the United States taxes income of "home" corporations wherever it is earned. The foreign tax credit was enacted in 1918 to prevent U.S. taxpayers from being taxed twice (once by the source country and again by the United States) on their foreign-sourced income.

The U.S. Treasury Department's tax "reform" proposal would significantly alter the effect of the foreign tax credit (FTC). For Caterpillar, the proposal would have about the same effect as repeal of the FTC. (Foreign taxes paid still would be allowed as a deduction.)

History demonstrates that Congress has refused outright repeal of the FTC. The more subtle Treasury Department proposal for repeal should be rejected as well.

The current foreign tax credit has not and will not lead to U.S. investment being shifted offshore. It is consistent with U.S. tax treaties, prevents double taxation, is less complex than the suggested Treasury revisions, and permits foreign investment to be a viable means of making U.S. economic contributions which otherwise would be forgone.

The FTC and U.S. Investment

Some advocates of eliminating the FTC argue to do so would force U.S. companies to supply foreign markets from the United States, providing more jobs and balance of payments benefits to this country. But as a recent editorial in the Journal of Commerce pointed out: "The idea that companies site their plants, refineries, etc. in low tax countries for the tax break just doesn't wash. Well-managed companies select foreign sites for substantial business reasons: labor costs, political stability, access to markets or raw materials."

Some countries, such as India and Indonesia, require a "local" investment before a firm is allowed to sell within their borders. So even if U.S. exports could compete successfully in these markets, they would not otherwise be allowed.

Repeal of the foreign tax credit could impose a combined effective tax rate of over 100 percent on some Caterpillar foreign-sourced earnings. Taxation of non-U.S. earnings at rates this high could make an investment overseas economically unattractive, but would not lead to increased U.S. investment. If an American firm is barred from exporting to a market by a prohibitive tariff or other barrier, or otherwise cannot compete successfully by shipping from the United States; and if American tax policy makes it impossible to compete by investing in that market country; then there is no incentive for investment.

Overseas Investments by American Firms and the U.S. Economy

Caterpillar's non-U.S. investments have significantly increased its positive contribution to the nation's balance of payments. In 1950, when the company made its first investment in an overseas manufacturing facility, that contribution was $94 million. Last year it was $1.4 billion, for a 10-year total exceeding $20 billion. Significantly increased exports and repatriation of profits earned overseas supported this growth.

Caterpillar's foreign investment provides opportunities for U.S. exports. For example, Caterpillar's York, Pennsylvania facility manufactures reusable hose couplings. One of York Plant's "best customers" for these is Caterpillar's Mossville, Illinois facility which produces hydraulic hose, ultimately shipped to many non-U.S. facilities for assembly into prime product. If these machines built overseas were manufactured in the United States, they could not compete successfully in some markets. So Caterpillar's foreign investment has had a significant positive impact on the York and Mossville plants and their employees.

In 1984 Caterpillar's non-U.S. manufacturing subsidiaries and affiliates purchased $236.4 million of U.S.-manufactured components and other production material from the parent company. Positive benefits of these foreign sales included their contribution to: payment of wages and salaries of U.S. employees; financing of capital expenditures to keep U.S. facilities modern; and financing of research and development vital to the long-term security of every Caterpillar employee.

In some cases, a firm's foreign investment might increase its sales throughout its entire product line, much of which may be U.S.- rather than foreign-sourced.

Business International periodically surveys the effects of U.S. business investment abroad on the U.S. economy. These analyses generally conclude that:

-- Foreign-investment-oriented U.S. companies have a more favorable impact on U.S. employment than other U.S. manufacturing firms.

-- Firms with higher percentages of foreign investment increase their U.S. exports faster than those with lower levels of foreign investment.

The excessive taxation which could result from the proposed FTC revisions would be more than an additional burden on foreign operations. It would, in effect, increase the cost of the U.S. exports which resulted from those operations. Such a tax policy change is especially unwise at a time of record trade deficits.

Tax Treaty Implications

Effective repeal of the FTC would be inconsistent with a series of U.S. tax treaties with other nations. Renegotiation of these treaties would be a time-consuming, costly effort, but necessary to protect U.S. business. Such renegotiation would be particularly difficult with the U.S. having changed the rules after earlier negotiations were complete.

THE FTC "LIMITATION"

A company's foreign tax credit cannot exceed its pre-FTC U.S. tax liability on foreign source income. For example, if a company has $50 of foreign source income, and assuming a 46 percent tax rate, the FTC "limitation" would be $23. Any foreign taxes paid beyond $23 would generate "excess FTC," which, potentially, could be carried back/forward to prior/subsequent profitable years.

The lower a company's "limitation," the more excess FTC it may have -- with the chance some FTC will be lost altogether. As the amount of foreign source income is reduced, so is the limitation.

Regulations developed to implement Section 861 of the U.S. tax code (hereinafter IRC861) have the effect of greatly reducing U.S. firms' foreign source net income. They require allocation or apportionment of all deductions (such as interest, depreciation, etc.), incurred within or without the United States, to all classes of gross income, including foreign source gross income. While diminishing the FTC limitation, the regulations appropriately recognize that U.S.-based expenses contribute to foreign earnings. By themselves, these regulations are generally unobjectionable.

PROPOSED CHANGES IN THE DEFINITION OF FOREIGN SOURCE INCOME

The current Treasury tax "reform" proposal suggests changes that would further reduce U.S. firms' foreign source income. But unlike the IRC861 rules, these proposals are not justified and do not treat the taxpayer equitably.

Present law generally results in the source of sales income being recognized as the place where the income is actually earned -- normally where ownership of the goods passes from the seller to the buyer. If a company has manufacturing operations, an appropriate portion of the income is also attributed to the place of manufacture. This rule is easy to apply and equitable because income is considered earned where the major income-producing activities take place.

The Treasury proposal would provide that sales income would have as its source the country of the taxpayer's residence, even though "residence" may have little to do with where the income-producing activities occur.

Treasury argues that the current "title passage" test to determine source of income results in income being shifted to low-tax jurisdictions. "For example," Treasury says, "income from certain sales may be sourced at any country by having the title pass there."

In fact, there are safeguards against arranging ownership passage (which entails more than title passage and is the determinant of the place of sale under current law) purely for tax benefit.

First, contractual agreement, and not tax policy, dictates where ownership will pass. For example, Caterpillar Americas Co. (CACo.), a U.S.-based wholly-owned marketing subsidiary of Caterpillar Tractor Co. (CTCo.), sells product to non-U.S. customers mainly in the Western Hemisphere. Because of the locations of its customers, the passage of ownership associated with most CACo. sales occurs upon arrival at the port of entry in the customer's home country (not some "artificial" low tax country). CACo. incurs ownership carrying costs and insurance charges and bears the risks of loss during shipment.

Where the passage occurs in the United States --as it did in $63 million of CACo.'s 1984 sales -- no foreign source income results. If CACo. were dictating ownership passage to insure tax benefit, this would not occur.

Second, the law prevents contracting ownership passage for purely tax avoidance reasons.

It has long been held that "where passage of title is formally delayed to avoid taxes . . . it is not necessary, nor is it desirable, to require rigid adherence to [the title passage] test . . .."* In short, Treasury already is empowered to address abuses arising from pro forma application of the title passage test, by looking to the substantive realities of the transaction.

Treasury argues that the "place of residence" rules it would substitute for the "title" passage test "reflect more closely the economic substance of the transaction." In fact, the opposite is true. Assume CACo. buys a Caterpillar D8 track-type tractor manufactured in Brazil, and sells it to a customer in Puerto Rico. Under present law, this sales income would be foreign-sourced.

But under the Treasury proposal, the income would be considered earned in the United States even though the tractor never entered the United States, and the CACo. employees who promoted the sale were in Puerto Rico.

In this example, U.S.-based CACo. activities provided support for the sale. Present law, IRC861, would apply expenses arising from these U.S. activities to the gross foreign-source income. Because CACo. is a U.S. taxpayer, income from the sale would be taxable in the United States. But if this income is considered U.S.-sourced, as Treasury proposes, then the Caterpillar enterprise would have significant excess FTC which would be lost, and CACo.'s income from the sale would be taxed twice -- in Puerto Rico and in the United States.

For enterprises like Caterpillar, this type of situation would occur regularly. As a result, the Treasury Department's proposed change in the definition of income-source, under either a per-country or overall limitation, would cause substantial excessive taxation.

The Treasury proposal seems to provide that if a U.S. company has a non-U.S. branch where the sale occurs, then income could be considered earned in that country. So, it could encourage U.S. firms to set up such branches, shifting current operations outside this country. This would reduce U.S. employment and increase taxes paid to foreign governments.

*U.S. v. Balanovski, 236 F.2d 298, 56-2 USTC¶9832, reversing in part 131 F. Supp. 893, 55-1 USTC¶9302, cert den. 352 U.S. 968 (1956, 2nd C.R.)

Caterpillar does not believe it has been adequately demonstrated that the current "source" rule has led to abuses. If it has, then it deserves attention, but moving to a destination test as currently used in the FSC provisions (or employing a combination of place of manufacture and destination) would be preferable to the Treasury proposal.

Special Concern for U.S. Exporters

Major U.S. exporters, by their nature, are more heavily weighted toward U.S. investment than U.S.-based firms whose strategy is to serve non-U.S. markets through foreign operations". This is one reason exporters are less likely to have production sites in low tax" countries. In fact, the foreign investment Caterpillar has made to compete successfully in some markets has been in relatively "high tax" countries.

So Caterpillar must generate low taxed foreign source sales income to have limitation sufficient to permit a U.S. FTC for the high foreign taxes on the company's non-U.S. operations. Caterpillar earns much of this foreign sales income from its U.S. exports.

The Treasury proposes, however, to revise the source rule for sales income -in a way that would make it extremely difficult to generate foreign source income through U.S. exports.

The result: A significant additional tax burden on major U.S. exporters. At a time of deteriorating U.S. competitiveness, tax "reform" should be moving in the opposite direction.

THE PER-COUNTRY LIMITATION

Under present law, the amount of foreign income taxes that may be claimed as a credit is subject to an "overall" limitation. All foreign taxes and foreign income are aggregated to determine the allowable tax credit. A U.S. taxpayer may apply limitation generated in one foreign country to obtain credit for taxes generated in another. In effect, there is an "averaging."

Treasury proposes replacing the overall limitation with a per-country limitation. Under the per-country method, a separate limitation is calculated for each foreign country.

Excessive taxation under the per-country limitation is inevitable. The U.S. determines FTC limitation by computing net foreign source income (gross income less deductions pursuant to IRC861). But the U.S. negotiated tax treaties permitting (even encouraging) foreign withholding taxes on gross income (income before considering expenses). This discrepancy can cause inequities even under the overall limitation, but that limitation system mitigates the harm because foreign tax credits generated in one country may be taken against limitation generated in another country (one in which, perhaps, little if any foreign taxes must be paid).

The following CTCo. example illustrates the two approaches:

	Per-Country Limitation		Overall Limitation	
Gross interest income earned in Canada	$100		100	
Gross interest income earned in Chile	100		100	
Total Foreign Source Income	200		200	
15% Canadian withholding tax (applied on gross income as prescribed by U.S./Canada tax treaty)		$ 15		$ 15
No Chilean withholding tax		0		0
Total Foreign Tax		$ 15		$ 15
U.S. expenses apportioned/allocated to non-U.S. income (pursuant to IRC861)			150	
Canada	90			
Chile	60			
CTCo. foreign-sourced net income			50	
CTCo. Canadian-sourced net income	10			
CTCo. Chilean-sourced net income	40			
FTC Limitation (46% of net foreign income; equals pre-FTC U.S. tax liability)			23	
Canadian	4.60			
Chilean	18.40			
Foreign tax credit			15	
Canada	4.60			
Chile	0			
Excess FTC	10.40	(Canadian)	0	
U.S. tax paid		$18.40		$ 8
Foreign tax paid		15.00		15
Total tax paid		$33.40		$23
Effective tax rate on foreign source income		66.8%	46%	

As illustrated, under the "per country" limit, $10.00 of the Canadian-source net income is subject to a $15.00 tax in Canada, and the United States would fail to allow FTC for $10.40 of the tax. In this example, the per-country effective tax rate is 66.8 percent of the total foreign income; in some cases the foreign, treaty permitted, withholding tax (on gross income) alone may well exceed 100 percent of the net income determined after applying IRC861.

Treasury points out the per-country limitation has been required in the U.S. before. But this was before effective implementation of IRC861. Both limitation and most foreign withholding taxes were generally computed on gross income. So many of the inequities which would arise today under the per-country limit did not result.

Treasury has said the current overall limitation "distorts investment decisions. A taxpayer has an incentive to generate low-taxed foreign income to utilize excess foreign tax credits. As a consequence, investments may be shifted from the United States to low tax countries."

For companies like Caterpillar, this simply is not true. Manufacturing facilities are located overseas for competitive reasons that go far beyond tax considerations.

About the time the overall limitation was mandated (in 1976), IRC904(d) was amended to deal with certain types of investment decisions which might have been distorted. Prior to the change, if a U.S. taxpayer had excess FTC, he might put money in a bank in a lower tax country where it would generate foreign-source interest income, which could result in additional limitation to which the excess FTC could be applied.

But IRC904(d) provides that such interest income ("interest other than interest derived from active conduct of the taxpayer's business") may generate limitation which can be used only to obtain FTC for foreign taxes on that same type of interest income.

In other words, a firm cannot manipulate that type of investment to exploit the overall limitation; and investments in plant and equipment, by their nature, simply aren't subject to such manipulation.

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IMPACT OF ADMINISTRATION TAX PROPOSALS ON FOREIGN TRADE OF INTERNATIONAL SERVICE ORGANIZATIONS

The President's tax reform Proposals of May 28 would impose a non-elective per-country limitation on the foreign tax credit and would change many of the rules for determining the source of items of income. These changes would dramatically alter the tax treatment of U.S. taxpayers that derive overseas income and foreign taxpayers that derive income from activities in the U.S. We believe that the proposed changes would undermine the ability of domestic concerns to compete in high-tax foreign countries. In addition, the Proposals would have a particularly harsh impact upon service corporations because of the unique nature of the international service business (as opposed to the manufacturing industries at which the proposed rules appear to be aimed). Some of the anticipated effects of the Proposals are discussed below.

Impact Upon U.S. Owned International Service Corporations

- The international service business must make its services available at the location where the client's needs are to be satisfied or the service is to be consumed or utilized. Unlike manufacturers who may produce in one country for consumption of their produce in several other countries, service businesses generally cannot elect a low-tax jurisdiction to produce their products for markup or sale to other jurisdictions.

- To compete effectively on an international scale, most international service businesses must be able to offer a world wide service on an integrated basis. Service businesses normally follow their clients around the globe. This often entails providing services in as many countries as possible regardless of tax rates, exchange restrictions, or even the ability to turn a profit in many parts of the world.
- An exception to the practice of rendering services in the location where they are used occurs in the technical assistance area, where the user country (generally less developed) is seeking services of highly technical nature from a more sophisticated country in which such expertise is available. This technical assistance service exception to the general practice currently presents a classic double-taxation problem under present law which, while taken into consideration under the proposals, is not adequately resolved.

- As a matter of tax policy, the per-country proposal removes from current law a system responsive to the problems of the service sector without meeting the Proposals' stated objective of eliminating the incentive for manufacturing and industrial concerns to locate in low-tax jurisdictions.

  - Manufacturing or industrial concerns could still choose low-tax jurisdictions for production with the products actually being consumed in other countries. Profits could be accumulated for reinvestment in those low-tax jurisdictions without repatriation to the United States.
  - In addition, according to the text of the President's Proposals, the revised sourcing rules would also attach greater significance to the jurisdiction in which the property is manufactured than to the location where the sales activities occur. (See Appendix for illustrations for these effects.) This would increase the incentive for domestic concerns to locate manufacturing facilities abroad in lower tax jurisdictions.

- By increasing the cost for the Service sector to render services in high-tax countries, per-country limitations as imposed by the Proposals could cause a reduction in the amount of services sold in such countries. The Proposals could therefore be detrimental from a balance of trade standpoint.
  - A worldwide calculation of foreign tax credits enhances the ability of U.S. taxpayers to compete in high-tax countries. This result occurs because taxes from such countries can be offset against profits from low-tax jurisdictions, reducing the total cost of selling products and services.

- An international service business may continuously incur losses in some countries because of its overriding necessity of maintaining a global presence. If these operations are conducted through foreign branches, as is often the case, the current system of offsetting foreign losses directly against foreign profits when computing foreign source taxable income in making the foreign tax credit calculation is far more sensitive to the worldwide nature of an international service business than the proposed system of offsetting losses.
- Under the proposed per-country system, these purely foreign losses would be partially offset against income from high-tax jurisdictions where the excess credits cannot be utilized to reduce the overall foreign tax cost. By not fully tax-effecting loss operations, the Proposals would penalize service business for fulfilling the competitive business need to maintain a presence in as many countries as possible.

- The proposed rules would be administratively unworkable for domestic taxpayers with international operations.
  - In determining their foreign tax credit, taxpayers would be required under the Proposals to allocate income on a country-by-country basis and then to apportion expenses and losses to such income. For example, income derived from activities occurring in

more than one country would have to be allocated among all of the countries in which such activities take place. Moreover, expenses such as overhead, stewardship, and interest would have to be apportioned among such countries. Consequently, the Proposals would give rise to a substantial additional record-keeping burden.

- Due to the inherent subjectivity of allocation and apportionment, the proposed rules would probably cause increased litigation on the part of multinationals who do not capture data on this level of detail.
- Taxpayers are presently required under present law only to allocate and apportion income and expense items between U.S. and non-U.S. sources.

Double Taxation - Technical Assistance Contracts

Under current law, income which is attributable to personal services is sourced in the jurisdiction in which the services are performed. In many instances where these services are of a highly technical nature, developing companies are seeking the services from more developed societies. Consequently, services may be rendered outside the jurisdiction where the end product (a factory blueprint, computer program, feasibility study, etc.) will be utilized. For example, technical services are frequently rendered within the United States, creating U.S. source income, while the gross payment for the service is subject to taxation in the country in which the service is utilized. Third world countries are not likely to have double taxation agreements with the United States, and often levy taxes on the gross payments for these services performed outside their boundaries.

- These conflicts between sourcing rules of the United States and foreign countries lead to economic double-taxation. Such double-taxation hampers our service companies' ability to compete against major competitors which have more favorable foreign tax credit systems that unilaterally recognize this double-tax problem.
    - The inability to bid competitively on technical assistance contracts impedes the ability of the technical assistance segment of the service sector to create additional jobs in the United States and exacerbates our balance of trade problems.
    - The President's Proposals recognize that this service problem occurs in the case of architectural engineering and related constructions services. The Proposals fail, however, to ameliorate the problem for management consulting, computer software, accounting, insurance brokerage, information systems analysis, marketing consulting, communications systems, and seismographic and other geophysical service systems in which the United States maintains a leading technical edge, but cannot effectively compete because of the double-taxation problem.

- The President's Proposals are helpful in that they would permit taxpayers to elect on a country-by-country basis whether to deduct or credit foreign taxes. Consequently, a taxpayer could obtain a deduction for foreign taxes in countries where it may have no foreign income or loss without losing the ability to take credits for other countries.
    - However, we do not support the President's per-country proposals for the foreign tax credit, and we do not believe that the Treasury would permit a per-country election between deduction and credit if the President's proposal is unacceptable to Congress. Therefore, we suggest that the double taxation problem be resolved even if the per-country proposal is found unacceptable to Congress.
    - We recommend that the sourcing rule for income derived from technical service contracts be conformed to the source rules for rental or royalty income derived from intangible property (i.e., such income would be sourced by reference to the place where the intangible product of services is utilized). This would put our technical service sector on a competitive footing with the tax laws of many of our trading partners.

Branch Profits Tax

- The proposals would provide a deterrent to foreign entities from locating facilities in the U.S. In addition, facilities that are presently operated as domestic branches might become economically unsound under the proposals. This disincentive to locate in the U.S. would result from the "branch profits tax" that would be imposed upon deemed repatriations from U.S. branches of foreign corporations.
  - The branch profits tax would increase the tax cost to foreign taxpayers of doing business in the U.S. Consequently, foreign corporations would be induced to save taxes by locating facilities outside the U.S.
  - The branch profits tax could potentially impose a triple-tax upon a U.S. shareholder of a controlled foreign corporation which is conducting business in the United States through a branch.
- The proposals would repeal the "80-20" rule regarding interest of dividends from U.S. corporations. This revision in the dividend and interest sourcing rules might impede foreign investors' willingness to invest in certain corporations carrying on operations in the U.S. The change would also create an unfair distinction between a U.S. incorporated bank and other financial entities (e.g., a U.S. incorporated 80-20 life insurance company which issues policies solely to non-resident aliens who are residents of non-

treaty countries) since interest paid on those life and annuity policies would be subject to the 30% withholding tax while interest on any bank deposit by a non-resident alien is currently exempt from U.S. taxations.

- Although "80-20" corporations must by definition derive most of their income from non-U.S. sources, some of their income may be attributable to U.S. operations. The proposal would increase the required pre-tax return for equity or debt investments in these corporations.

APPENDIX

EXAMPLE: Assume that Company A is a domestic manufacturer of computers and office equipment that has decided to market its products in the Far East. Company has determined that, from a strategic standpoint, it should market a line of products in Japan for the next few years. The company has forecasted annual Japanese sales of $10,000 for the product line. Units for each year's far east sales can be produced at A's domestic facility for $5,000. Alternatively, A could establish a Hong Kong facility to produce them at a total yearly cost of $5,500.

Company A's present operations are expected to yield $1,000 U.S. source taxable income and $2,500 of taxable income from French sources. France, Hong Kong, Japan and the U.S. impose income taxes at flat rates of 50%, 16%, 42% and 33%, respectively.

Company A would recognize annual taxable income of $8,500 if the manufacturing operations are conducted domestically. It would pay taxes of $2,100 to Japan and $1,250 to France each year. It would have an annual tentative U.S. tax liability of $2,805 which, after reduction by a foreign tax credit of $1,650, would result in a total U.S. tax liability of $1,155. Consequently, A would pay a total of $4,505 domestic and foreign taxes each year, leaving it with after-tax income of $3,995.

If per-country limitations are instituted and the income sourcing rules are changed as the President proposes, A's total annual foreign tax credit would be limited to $1,237 ($412 from Japan and $825 from France), resulting in total U.S. tax liability of $1,568 ($2,805 tentative tax less $1,237 of credit) for each year. A's annual after tax profit would therefore be $3,583 under the President's proposals if it conducts its manufacturing operations in the U.S.

As mentioned above, A could produce its product line in Hong Kong at a total annual cost of $5,500. Because of the additional cost of manufacturing overseas, A's annual pre-tax income would be only $8,000. However, A's U.S. taxable income would not include amounts received from Japanese sales. Therefore, A's U.S. taxable income would be only $3,500, and A's foreign tax credit would be $825 (attributable to France). Consequently, A's annual U.S. tax liability would amount to $330, and A's annual worldwide tax liability would be $4,190. A's after-tax net income for each year would consequently be $3,810.

In summary, A's after-tax profit under current law from producing the product line in the U.S. and selling it in Japan ($3,995) would be greater than the amount that it would earn from producing its goods in Hong Kong ($3,810). However, its profit where the product line is produced in Hong Kong is greater than the profit that would arise from manufacturing its product line in the U.S. if the President's Proposals are adopted ($3,583). Consequently, economics would dictate that A establish the Hong Kong facility if a per-country limitation is adopted. In such event, the U.S. would lose direct tax revenue of $825 from A, as well as indirect economic benefits (e.g., employment).

The table on the next page presents the assumptions and alternative calculations of A's foreign tax credit.

APPENDIX - Continued

	Worldwide Limitation		Per-Country Limitation	
	Manufacture in U.S.	Manufacture in H.K.*	Manufacture in U.S.	Manufacture in H.K.*
Japanese sales (gross)	$10,000	$10,000	$10,000	$10,000
Allowable expenses	5,000	5,500	5,000	5,500
Net Income Sales	$ 5,000	$ 4,500	$ 5,000	$ 4,500
Foreign Source T.I.:				
Japan Source**	$ 2,500		$ 1,250	
French Source	2,500	$ 2,500	2,500	$ 2,500
Total	$ 5,000	$ 2,500	$ 3,750	$ 2,500
U.S. Source T.I.:				
From Japan Sales**	$ 2,500		$ 3,750	
From U.S. operations	1,000	$ 1,000	1,000	$ 1,000
	$ 3,500	$ 1,000	$ 4,750	$ 1,000
U.S. Taxable Income	$ 8,500	$ 3,500	$ 8,500	$ 3,500
U.S. Tentative Tax	$ 2,805	$ 1,155	$ 2,805	$ 1,155
Foreign Taxes:				
Japan	$ 2,100	$ 1,890	$ 1,100	$ 1,890
Hong Kong		720		720
France	1,250	1,250	1,250	1,250
TOTAL	$ 3,350	$ 3,860	$ 3,350	$ 3,860
Foreign Tax Credit:				
Overall	$ 1,650	$ 825		
Japan			$ 413	
France			825	$ 825
Total	$ 1,650	$ 825	$ 1,238	$ 825
Federal Income Tax Liability	$ 1,155	$ 330	$ 1,568	$ 330
Income Summary:				
Income-U.S. Operations	$ 1,000	$ 1,000	$ 1,000	$ 1,000
-French Operations	2,500	2,500	2,500	2,500
-Far East	5,000	4,500	5,000	4,500
Total	8,500	8,000	8,500	8,000
Less: Taxes	4,505	4,190	4,918	4,190
AFTER TAX PROFIT	$ 3,995	$ 3,810	$ 3,583	$ 3,810

* Manufacturing operations would be conducted by a Hong Kong subsidiary. Cash profits would not be repatriated.

** Under present law, income sales in Japan would be sourced 50% in Japan (country of sale) and 50% in the U.S. (country of manufacture). The President's proposals do not specify the relative weights that they would accord the jurisdictions of sale and manufacture. We have assumed that income would be sourced 25% & 75% to Japan & U.S., respectively.

CBEMA

STATEMENT OF

GERALD K. HOWARD

VICE PRESIDENT OF THE TAX PLANNING AND TAX COUNSEL

OF THE

SPERRY CORPORATION

BEFORE THE

SENATE COMMITTEE ON FINANCE

SEPTEMBER 1985

Computer and Business Equipment Manufacturers Association

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My name is Gerald K. Howard. I am Vice President of Tax Planning and Tax Counsel of Sperry Corporation located in New York City. I am appearing today on behalf of the Computer and Business Equipment Manufacturers Association (CBEMA). CBEMA is an association composed of 39 manufacturers of computer systems, sophisticated business equipment and other high technology electronics products.

CBEMA believes that tax reform can be a positive step in transforming our tax system to meet the increasingly high technology orientation of the U.S. economy. Because of the high technology nature of their businesses, CBEMA members consistently have effective tax rates higher than that of most U.S. industries under the present system. Studies by the Joint Tax Committee and by the publication Tax Notes consistently indicate that the computer industry has had effective tax rates ranging from 40 to 60 percent higher than average corporate rates. This results because the computer business is research-intensive as well as capital-intensive. Moreover, the capital investments of the computer industry are largely in equipment and manufacturing facilities which rapidly become technologically obsolete.

Given the nature of its industry, CBEMA can support tax reform which would achieve the following goals:

- reduce corporate tax rates
- give top priority to R&D incentives
- provide incentives for capital investments that apply to short-lived as well as long-lived assets; and
- recognize that the taxation of international operations affects the international competitiveness of U.S. companies.

The President's tax proposals in many ways take positive steps towards accomplishing these goals. However, we urge that the Committee refine the proposals in several respects.

Reduction in Corporate Rates

CBEMA applauds the efforts reflected in the President's proposals to reduce corporate rates. The current high level of corporate rates together with a relatively narrow tax base has produced a system which yields widely differing effective rates of tax in different industries. In many ways it has worked to the disadvantage of the high technology sectors of the U.S. economy. The basic reform concept of closely scrutinizing incentive provisions, eliminating or reducing those that are outmoded or overly generous (while preserving those that continue to serve important economic purposes), and utilizing the revenue to reduce corporate rates is a positive step. It will hopefully lead to increased investment in industries which today are relatively highly taxed, like that of CBEMA members.

Priority Incentives for R&D

Notwithstanding the general movement toward a broader base, lower rate tax system, it is extremely important that tax reform permit the continuation of those tax incentives which are important to the future of our nation's economic activity and to our industry's industrial competitiveness worldwide. Primary among these is the R&D tax credit.

The R&D credit was enacted in 1981 and is currently scheduled to expire at the end of 1985. Several recent studies, including one by the Congressional Research Service, have concluded that the credit should be extended and indeed made permanent even in the context of broad base tax reform. The reasons for this conclusion are quite apparent. Unlike virtually any other activity which might be encouraged through the Internal Revenue Code, the benefits of R&D investments are not captured fully by those taxpayers making the investments. Instead, the benefits quickly spread throughout the economy, improving the quality of life, worker productivity and our gross national product. These benefits from R&D, which accrue to the country generally but not to the party investing in R&D, make a compelling case for governmental policies to increase the level of R&D undertaken by the private sector.

The current R&D tax credit fulfills this vital policy need. A study by Martin Bailey and Robert Lawrence (of the Brookings Institution) and by Data Resources, Inc. concludes that the R&D tax credit has been successful in generating sufficiently substantial increases in R&D to justify the revenue cost of the credit. Under relatively conservative assumptions, the authors find that a permanent R&D tax credit would generate from $1.2 to $7.5 billion of annual GNP increases in 1986 and from $2.9 to $17.7 billion of GNP increases by 1991. Such a credit currently costs the Federal Government something less than $1.5 billion per year.

These increases in GNP resulting from the R&D credit apply whether or not the corporate tax rate is reduced by tax reform. Indeed, the Congressional Research Service points out that:

> The reduction of the tax rate, which is the trade-off for losing tax preferences, may not be very valuable in the case of R&D investments which are highly risky. The lower tax rate may increase potential return, but it also increases variability in return. Thus, the tax rate reductions may actually have a negative impact on R&D investments and justify a retention or increase in the subsidy [i.e., the R&D credit].
>
> [Congressional Research Service, "The Tax Credit for Research and Development: An Analysis," January 25, 1985, at p. 41.]

The President has recognized the continuing need for incentives for R&D by proposing a three-year extension of the R&D tax credit. This is a most important part of the President's tax proposals. However, CBEMA strongly believes that a three-year extension of the credit is insufficient. In the computer industry major R&D projects typically take longer than three years -- five to six years in many cases. Thus, if the credit is to have its full potential impact on R&D spending, it must be extended for a much longer period of time than three years. CBEMA believes the credit should be made a permanent part of the Internal Revenue Code.

The President's proposals do not allow the R&D credit against the proposed corporate alternative minimum tax. While this proposal will lessen the effectiveness of the credit for some taxpayers, CBEMA does not oppose this provision. It does, however, oppose other minimum tax proposals which disallow most deductions for corporate R&D expenditures. Any corporate minimum tax proposal is intended to ensure that all profitable corporations pay some minimum level of taxes regardless of their use of various incentive deductions, exclusions or credits in the Code. In this context it is appropriate that the R&D tax credit, which is clearly intended as an incentive to private research, not be allowed to reduce a taxpayer's minimum tax. However, it is also clear that the deductions taken by taxpayers for R&D expenditures -- *i.e.*, the salaries of R&D personnel, their supplies and other related costs -- should be currently allowed. This result should occur for the following reasons:

- R&D expenditures are required to be deducted for financial reporting purposes to shareholders and to the SEC. Consequently, no profitable corporation can pay taxes below any designated minimum effective tax rate (based on financial income) because of the deduction of R&D.
- The Internal Revenue Code provision permitting R&D to be deducted was enacted in 1954 to provide certainty and consistency of treatment, not to establish an incentive for R&D expenditures.

- In other major countries of the world R&D expenditures are deducted for both tax or financial accounting purposes.
- Disallowing R&D deductions under a minimum tax will cause a major tax increase to high technology companies which already pay relatively high effective rates of tax.

Investments in Short-Lived Equipment

Incentives for Investments.

Prior to the enactment of the Accelerated Cost Recovery System (ACRS), most computer and office equipment was depreciated over a five-year period at a double declining balance rate. Similarly, the manufacturing equipment of computer and other high technology companies was depreciated over five years prior to 1981. This depreciation was roughly consistent with the depreciation for financial purposes of most major companies. Thus, the enactment of ACRS, which provided for five-year depreciation on a less than double-declining balance basis, provided little if any tax benefit to the equipment of CBEMA members. Indeed, in many cases the tax depreciation of this equipment under ACRS was slower than depreciation for financial accounting purposes.

At the same time, the investment tax credit has since its enactment in 1962 been a substantial incentive for new investments by CBEMA members and, even more importantly, by their customers. Computers and other high technology equipment of CBEMA members are primarily used by America's businesses. In recent years an increasing portion of America's business investment has been of high technology computing and other electronics equipment. Some estimates for 1983 indicate that over 40 percent of capital spending for new equipment during that period was invested in electronic automation equipment. By encouraging these investments, the investment credit has been a major policy instrument through which the tax code has increased the productivity and efficiency of U.S. businesses in all industries. Thus, CBEMA members are seriously concerned that the loss of the investment tax credit, particularly if undertaken percipitously, could have a significant adverse impact on U.S. capital investments in general and in high technology products in particular.

At the same time, CBEMA recognizes the central role that the ultimate elimination of the investment credit plays in any rate reducing tax reform legislation. Thus, CBEMA does not actively oppose the investment credit elimination.

However, if the investment credit is to be repealed, it is vital that any tax reform package include a system of depreciation which provides substantial incentives for investments in new plant and equipment and which, like the investment credit but unlike ACRS, benefits short-lived as well as long-lived assets. The Administration's Capital Cost Recovery System (CCRS) in principle accomplishes this result. Under that system computers and other electronic office equipment, for example, are included in Class 2 and are depreciated at a 44 percent declining balance rate. This classification recognizes the existence of actual short economic lives for this equipment and applies a rate of depreciation which does provide significant incentives. It partially, although not completely, offsets the impact of eliminating the investment tax credit.

However, while CBEMA generally endorses the Administration's CCRS proposal, it believes that a serious effort needs to be undertaken by the Congress in refining the Administration's classification of various other types of high technology equipment. As is indicated above, the Class 2 treatment of computers and other electronic office equipment is appropriate. However, most telecommunications equipment currently being placed in service in the newly deregulated telecommunications industry are virtually identical to computers. Yet, the Administration's proposal places this equipment in Category 4, with general industrial equipment. Such equipment is permitted depreciation at only one-half the rate for computers. The clear convergence of the computer and telecommunications industries and of the technologies underlying their products strongly suggests that this dissimilar treatment is inappropriate.

Equally importantly, manufacturing equipment in the electronics industry -- most importantly, the wafer fabrication equipment used to build integrated circuits and other semiconductor devices -- is also improperly classified for depreciation purposes. This equipment is also placed in Class 4 as general industrial manufacturing equipment. However, because of the rapid technological innovation in the electronics industry, manufacturing equipment is in fact subject to rapid economic obsolescence. Semiconductor manufacturing equipment, for example, has an economic life of five years or less; it should therefore be in Class 1. Yet, the equipment is proposed to be depreciated in Class 4 with railroad tracks and public utility property. This classification obviously must be modified to recognize the economic and technological realities of the electronics industry.

In the President's proposal Treasury acknowledges that it may have incorrect lives for both telecommunications and electronic manufacturing equipment. The Treasury proposes that a new Treasury office be established to study actual depreciation rates and, based upon the study, to reclassify assets for tax depreciation purposes. While this procedure is necessary, it could take a substantial time (e.g., three to five years) after tax reform is enacted before assets would begin to be reclassified. In the meantime, the inappropriate treatment would be applied.

Where the discrepancies between the classifications set forth in the President's proposal and actual economic depreciation (based, for example, on depreciation for financial purposes of the companies) are substantial and obvious, we believe Congress should not merely delegate reclassification authority to the Treasury Department. Rather, Congress should itself act on the best evidence available and establish its own generalized classification system. Treasury could then make further adjustments through its studies where appropriate.

Short-lived Equipment and the Windfall Recapture Proposal.

Besides, under the CCRS system, the short actual useful lives of electronic equipment must also be recognized under any proposed recapture tax on "windfall" benefits such as that included in the President's proposal. The concept of this windfall recapture is novel to the U.S. tax laws and raises serious issues. However, whatever its problems in principle, the specific proposal by the Administration is seriously flawed.

As proposed, the tax is intended to recapture any tax benefit from the reduction in tax rates from 46 percent to 33 percent with respect to accelerated deductions under ACRS. This requires some measurement of the acceleration of deductions received under ACRS (so-called "excess depreciation"). Treasury specifies that the correct measure of excess depreciation should be ACRS depreciation in excess of true economic depreciation. To measure this amount, the proposal takes the difference between ACRS depreciation deductions and the amount which would have been allowable if the straight-line method of depreciation specified under Section 312(k) for measuring earnings and profits had been used. Unfortunately, Section 312(k) uses for all five-year equipment a 12-year straight-line measure of economic depreciation. For high technology equipment, which as described above depreciates over five or fewer years, the use of 12-year straight-line to measure "excess depreciation" under the windfall recapture proposal will cause enormous amounts to be subject to the tax where in fact no benefits at all were received under ACRS. In this context, the recapture tax measured by a 12-year straight-line depreciation is nothing more than a penalty tax.

Thus, whatever the merits of the concept of excess depreciation recapture given the substantial reduction in corporate tax rates, the system can only work as intended if some relatively precise concept of economic depreciation is utilized. Perhaps the easiest measure of economic depreciation for publicly-held companies would be the difference between tax depreciation for the covered period and depreciation taken for financial accounting period. This data is already available. Since it would apply in virtually all instances to prior periods, companies could not change their rates of depreciation for financial purposes with tax consequences in mind. Moreover, under such a measurement, the tax would hit the precise "windfall" intended to be taxed by the Treasury Department: the amount by which a company's earnings is improved with respect to prior investments due to the reduction in the tax rate.

We recognize, however, that utilizing financial reporting data may not be feasible with respect to small and privately held taxpayers. In this case depreciation as measured for some other purpose (e.g., for foreign-owned assets) would be appropriate.

Short-lived Equipment and Minimum Tax Proposals.

The same issue of proper useful lives for high technology equipment applies in the context of any proposed corporate alternative minimum tax. Many of the minimum tax proposals which this Committee will be considering include some measure of the acceleration in depreciation as a preference. CBEMA does not object to this in principle. However, as under any windfall recapture tax, the measure of any accelerated depreciation must take into account the actual rapid depreciation rates and short economic lives of high technology equipment. Otherwise, amounts will be treated as a preference and subject to minimum tax when in fact no benefits have been received by the companies in question and thus no minimum tax is properly due.

Tax Treatment of International Operations

CBEMA members, and high technology companies in general, invariably have large international operations. The costs inherent in the R&D efforts to develop a new generation of products are sufficiently high that each generation of products must be sold in the broadest possible marketplace to provide needed revenues. Therefore, U.S. companies must compete for foreign markets. If U.S. companies are not competitive in these markets, foreign companies will develop a broader earnings base from which to finance larger R&D activities to develop their own future products. These future products will then be competitively superior to U.S. products not only in foreign markets but in the United States. Thus, U.S. companies must be competitive in foreign markets in order to remain competitive over the long-run even within the United States. Consequently, the U.S. tax treatment of both the foreign operations of U.S. companies and U.S. exports is of vital importance to CBEMA members. Unfortunately, two of the President's tax reform proposals with respect to the tax treatment of foreign operations of U.S. companies represent a significant backwards step.

Per-Country Limitation on Foreign Tax Credit

The President proposes that the foreign tax credit limitation of present law be changed from an overall to a separate country computation. Under this so-called "per country" limitation approach, taxpayers would be required to separately compute their foreign tax credit for each country in which they have operations.

In the view of CBEMA members, the per-country limitation is wrong in concept and is in practice impossible to apply accurately. CBEMA members operate in as many as

50 to 80 countries of the world. These operations are not separate and distinct for each country. Rather, these operations are organized on a regional or, in many ways, a worldwide basis. A typical CBEMA member may, for example, organize its European operations with its regional headquarters and distribution company in Belgium, manufacturing operations in the United Kingdom, Germany and/or Ireland, and sales companies in each European country. One or more additional affiliate may perform R&D in the United Kingdom. Currency risks, marketing expertise, and to some extent technical expertise will be centralized in the Belgian company. Products developed in the United Kingdom and manufactured in Germany could be sold to the regional distribution affiliate and later resold to a local sales company with technical assistance for the Belgian headquarters company. U.S. exported goods similarly would be sold to the regional distribution company and then resold to local sales affiliates.

Under this pattern of organization, the European operations of the affiliated group are in most ways an integrated whole. Yet, the per-country limitation on the foreign tax credit would require that these operations be segregated by country. Arbitrary determinations would have to be made of the source of income and the allocation of deductions to provide a separate country computation for foreign tax credit purposes. Such arbitrary delineations make no economic or business sense. Moreover, auditing the allocations made by taxpayers in any effective manner is likely to be beyond the capability of the Internal Revenue Service. Thus, the per-country limitation is unworkable in practice, as well as incorrect in principle.

Tax Treatment of U.S. Exports.

In addition, the President's proposal increases the taxation of U.S. exports by eliminating any foreign source income from the sale of most goods manufactured in the United States. The Foreign Sales Corporation (FSC) provisions enacted last year reaffirmed that up to 25 percent of the total taxable income earned from U.S. export transactions should be treated as foreign source income and eligible for the foreign tax credit. For exporters with substantial foreign operations, this treatment effectively reduces the U.S. taxation of exports by substantial amounts. Its elimination by the Administration's proposal would increase U.S. taxation of exports. At a time when our trade deficits are at record levels, such a change in tax policy would seem to make little sense.

Conclusion

CBEMA believes that tax reform can be a positive step in conforming our tax code to the increasing high technology nature of the U.S. economy. Basic changes are needed in the President's international tax proposals. But for domestic taxation, the basic concepts of reduced tax rates, incentives for R&D and incentives for short as well as long-lived equipment establish positive principles for true tax reform. However, refinements to these principles are needed in some areas -- particularly in the treatment of short-lived equipment for CCRS and recapture tax purposes.

United States Senate
COMMITTEE ON FINANCE

HEARING ON THE EFFECT OF TAX REFORM ON AMERICAN BUSINESS

STATEMENT OF ERNSTY & WHINNEY

Presented by David A. Berenson

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INTRODUCTION

Taxes and Public Perception

The federal income tax has existed for more than 70 years. For the greater part of this period it has been a fair, effective and well accepted means of financing the government. Over the past 10 years, however, it has been increasingly perceived by taxpayers as less fair and less effective. As a result, its public support has declined. We agree with many members of this Congress that if taxpayer confidence in the income tax system is as low as reported, now is the time to reform it. But, any reform proposals need to be carefully considered.

Tax reform should not be represented to the American people as "simplification" if it is not simple; nor should it be represented as "reform" if it is not so. People tend to think of "reform" in a connotative sense as an improvement, not in the denotative sense as a reformulation.

Although we have had a number of reformulations recently -- referred to as "Reform Acts," we believe that the average taxpayer has not perceived those changes to be a major improvement of the system. This likely increases individual frustration and may influence the level of compliance resistance.

The Role of Complexity

Some 200 years ago, Adam Smith stated that taxes "ought to be certain, not arbitrary." Essentially he was saying to us that an income tax should not be capricious. Certainty is necessary in the operation of a tax system for two reasons: first, certainty enables the tax system to be understood, permitting taxpayers to plan their financial affairs knowing the tax implications. Second, certainty is essential to strengthening voluntary compliance by preserving taxpayer morale. At present, the degree of certainty in our system is less than ideal.

The number of rules in the Code and their varying interpretations has increased dramatically during the last 30 years, with an attending proliferation of complexity. This has occurred in the oft-stated pursuit of at least five specific tax policy objectives:

1. Attempt to increase certainty by making tax laws more detailed so their interpretations are more precise;
2. Strive to create a more equitable system by providing more exact specifications for income, deductions, exemptions and credits, many of which require new code sections or expanded versions of old ones;
3. Attempt to close actual or perceived "loopholes" that do not advance the purpose of the Code provisions or that allow transactional tax benefits beyond those intended or deemed appropriate;
4. Provide transitional rules for new provisions to allow taxpayers who relied upon prior law ample time to adjust their affairs; and
5. Strive to attain social and economic objectives by creating tax incentives or disincentives to particular courses of action.

Creating a more equitable system, the second objective resulting in additional complexity, is particularly troublesome and produces ironic results. The complexity that was added to the law over the past 10 years to produce a fairer (i.e., a more equitable) system seems to have created a general distrust of the system by individual taxpayers, especially those who do not understand the tax system and cannot afford expert tax advice to explain it. Furthermore, lack of understanding also seems to breed distrust in the fairness of our tax system, a conclusion supported by the findings in several recent taxpayer surveys.

To summarize then, complexity of our present tax laws is, in part, a direct by-product of attempts to promote equity. But in fact, complexity has led to a misunderstood tax system that is perceived as inequitable. Successive attempts to achieve further equity -- supported by unprecedented governmental and media publicity of "abuses" to be rectified -- has resulted in the perception by taxpayers that this goal is not being realized, despite continual "reform" legislation. Taxpayer morale and the level of voluntary compliance have declined; perhaps this has occurred in part as a result of the lack of positive commentary on any aspect of the present system or the effects of previously enacted "reform."

If a complex tax system is not acceptable, then a simple one would appear to be the solution. For example, a simple system such as a proportional tax on annual gross receipts would, at first glance, seem acceptable because its simplicity makes it understandable. Nevertheless, it would probably soon be recognized as unfair.

Tax policymakers are therefore in a quandary: complex systems are not understandable and are thus perceived as unfair, and yet simple systems are, in fact, unfair. Obviously, some middle road that actually simplifies the existing system while improving the degree of fairness should be the goal of the current efforts by all concerned citizens.

Problems in Base Broadening

We support base broadening coupled with rate reduction as a tax policy goal. However, it should be understood that base broadening might increase the level of complexity. This could occur because major changes will need to be accompanied by transition rules and prospective effective dates. For example, Treasury II would eliminate capital gain treatment for the disposition at a gain of depreciable property placed in service after 1985. Since the proposal would not affect depreciable property placed in service before 1986, existing Section 1231 treatment would continue under Treasury II for many, many years. And, more importantly, additional complexity will result from untested new rules (lacking authoritative interpretations) for measuring the additional inclusions in income or eliminating prior deductions.

RETROACTIVE AND TRANSITIONAL TAX POLICY ISSUES

The Administration made a significant effort to avoid retroactivity by proposing prospective effective dates for all provisions of Treasury II. In addition, ranking members of the Congressional tax-writing committees gave assurances that no new law that would restrict investment benefits would take effect prior to 1986. These efforts and assurances arose from a general concern for the ability of taxpayers to plan their financial affairs with some certainty of the tax consequences. However we are concerned that several of the President's tax proposals have a substantial retroactive effect. For example, under the proposals, rehabilitation expenditures incurred after 1985 will not qualify for the rehabilitation credit even if a binding contract to rehabilitate the building was entered into when existing law allowed such a credit. Moreover, such a contract and the economics of the transaction may have been established even before last

November's Treasury proposal. Also, consider, for example, the effect enactment of Treasury II would have on a Clifford trust established by parents two years ago for their eight year-old child. Under current law, the trust is taxed as a separate entity. However, beginning in 1986, Treasury II would no longer tax the trust. Instead, the child would pay taxes at the parents' rate, regardless of whether income could actually be distributed to the child under the terms of the trust instrument and even though Clifford trusts are irrevocable.

Several other proposals have a similar retroactive effect. These include:

- Repeal of ACRS for property acquired or under construction but not "placed in service" prior to 1986.
- Recapture of "excess" depreciation taken between January 1, 1980 and July 1, 1986.
- Repeal of capital gain treatment for business property acquired or under construction but not "placed in service" prior to 1986.
- Limitation of deduction for interest expense on indebtedness incurred prior to 1986.
- Changes in the tax treatment of retirement savings, including the repeal of hardship withdrawals on cash or deferred arrangements, and changes to the plan loan provisions.

As accountants and business advisors, we can assure you that taxpayers who are adversely affected by retroactive application of statutory changes will not view those changes as either "reform" or "simplification." Thus, we believe equitable phase-in and "grandfather" rules should be enacted to avoid the hardships that would otherwise result under the proposals.

Further, it has been argued that the equitable quid pro quo for rate reduction is the revenue enhancement of eliminating grandfathering provisions. However, since there are clear winners and losers under these proposals, the equitable quid pro quo argument lacks fundamental fairness to those who become retroactive losers at the price of other taxpayers' prospective rate reduction benefits.

INDEXATION AND TAX POLICY ISSUES

The Administration proposes to index for inflation, capital gains, depreciation, FIFO inventory, certain retirement plan limits, and the earned income tax credit. Current law already adjusts tax brackets, the zero bracket amount and the personal exemption for increases in the consumer price index.

While indexation may be theoretically appropriate in an economic sense, we question whether the complexities of further extending indexing are justified in periods of relatively modest inflation. After all, indexing was only adopted in 1981 following a period of double-digit inflation. Prior to this, as a practical matter, the "pain" of taxing inflationary gains was outweighed by the benefits of historical cost recordkeeping for capital assets, depreciable assets and inventories. Consequently, we believe indexing should be extended beyond its current application only when inflation exceeds a predetermined rate.

Complexity Vs. Simplicity

Indexing for inflation came into vogue during the 1970's, when we experienced double-digit inflation. Once people realized they were losing purchasing power, they perceived that indexing was needed to avoid "bracket creep" and to avoid the erosion of fixed dollar benefits (or deduction limits) when there is rapid general inflation. However, inflation levels have not been high recently, and, as a result, the purchasing power of most taxpayers has not decreased significantly.

During periods of low inflation, we believe the complexities of indexing are not worth the benefits derived from applying such a new concept to an already complex system.* For example, indexing would place a greater reporting and recordkeeping burden on most taxpayers. However, neither the concept nor the practice of adjusting for inflation is easily grasped by the general public. Therefore, unless the Internal Revenue Service can provide a simple explanation of the rules or can automatically adjust an item (as is done currently), taxpayers will have to employ professional tax advisors to understand and apply the new rules to their situation.

On the other hand, when inflation is at a very high level (*e.g.*, double digit), an additional degree of complexity may be necessary in order to achieve fairness. Therefore, we are supportive of broadly applicable indexation only when inflation exceeds an acceptable, predetermined level, for example, when inflation is 6% or higher. This approach would use a "trigger" mechanism that would only require an adjustment at the end of a year in which, and to the extent that, inflation exceeds an acceptable, predetermined level.

Perception of Fairness

Inflation adjustments are commonplace in modern-day America -- witness, for example, the widespread use of cost-of-living adjustments for collectively bargained agreements, and for Social Security benefit purposes. There is a common perception that indexing an item for inflation is always desirable. However, we believe the broad extension of indexing in our tax system will eventually be subject to criticism. For example, a large segment of the public already believes that businesses receive too many tax breaks. When the impact of the Administration proposal to index depreciation deductions to achieve a total benefit substantially in excess of historical cost (the CCRS proposal) is fully understood, the average taxpayer's belief in the fairness of our tax system may further deteriorate. Also, when property is sold at a substantial dollar gain over its cost, and its owner is not subject to tax, or may even receive the benefit of loss treatment in inflation-adjusted dollars, these taxpayers and others are likely to believe that the tax system unfairly favors business taxpayers (and the wealthy).

There may be additional perceived unfairness, since inflation rates for a specific industry or geographical location will typically differ from the average rate used for indexing. As a consequence, there undoubtedly will be unintended winners and losers in the indexation environment.

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* The complexity of indexing has been recognized by the Administration, at least in part, as evidenced by its decision to eliminate indexing for interest income and expense as proposed in Treasury I.

BUSINESS AND CAPITAL FORMATION

NEW CCRS DEPRECIATION SYSTEM

For assets placed in service after 1985, the Administration proposes to create two new depreciation systems: one for domestic assets, and another for foreign assets. Both would index depreciable basis for inflation, a concept not incorporated in the current accelerated cost recovery system (ACRS).

While indexing may be theoretically appropriate in an economic sense, we do not believe that the resulting complexities are warranted when inflation is relatively modest. Rather, in our view, the differences between the Administration's proposed depreciation system and ACRS are not so significant considering our present rate of inflation to warrant adding another depreciation system to a list which already includes IRS Bulletin F, the class life system, the asset depreciation range system, and ACRS. This is especially true absent evidence that ACRS has failed in some significant way. What taxpayers really want -- and need -- is consistency and certainty, since capital expenditure budgeting is often done well in advance. If there are certain assets that truly receive an unwarranted economic advantage under ACRS, addressing them individually through new classes or extended lives would be preferable to rewriting our entire depreciation system. Thus, we recommend not indexing depreciation deductions except to the extent inflation exceeds an acceptable predetermined rate.

In addition, should our recommendation concerning indexed depreciation deductions be adopted, and should Treasury II's proposal regarding elimination of Section 1231 treatment for depreciable property be enacted, taxpayers should be allowed to index the unrecovered cost of assets at the time of sale. In such circumstances, indexation would be warranted since gain on the sale of such property would be taxed as ordinary income rather than as capital gain. Any resulting complexity could be minimized by providing tables which integrate the adjustments necessary because inflation exceeded a predetermined threshold. Also, unlike the annual inflation adjustments proposed under Treasury II, these tables would only be used at the time an asset is sold.

EXCESS DEPRECIATION RECAPTURE

The Administration proposes to subject taxpayers whose total depreciation deductions between 1980 and 1985 are at least $400,000 to mandatory recapture of a portion of those deductions. Although the stated purpose of the proposal is to prevent a "windfall" from the proposed reduced tax rates, the proposal would apply regardless of whether a "windfall" is actually realized. In addition, the proposal raises several tax policy issues. First, proper tax policy should permit taxpayers to enter into transactions under current law without fearing new, retroactive legislation. The recapture proposal departs from this well accepted principle by penalizing certain taxpayers who depreciated property under ACRS and other accelerated depreciation methods. The proposal is also contrary to statements by leaders of the Congressional tax-writing committees contemplating only prospective application of any tax reform legislation.

Second, the proposed recapture rule is a departure from the well established ability-to-pay concept, and from the basic principle that unrealized gain should not be taxed. For example, a taxpayer who previously sold an item of recovery property without recognizing gain, or who is currently holding a piece of property on which gain has yet to be realized, may be subject to recapture. Only taxpayers with net operating losses carried forward from a taxable year before 1986 would receive relief. Thus, because of this forced recognition of fictitious or unrealized gains, the result may be severe cash-flow problems for many taxpayers and a slow-down in capital formation.

Third, the complexity and inequity of this rule is also inconsistent with an underlying policy of tax reform: simplicity. For example, the calculations necessary to determine if taxpayers are subject to recapture differ from those necessary to determine the amount recaptured as income. Further, the calculations relate to depreciation deductions taken on property placed in service at varying dates and taken over different periods of time. Also, taxpayers would be required to compute hypothetical depreciation deductions with property lives used to determine a corporation's earnings and profits. In addition, gathering the details necessary for these calculations would be extremely burdensome on taxpayers. For example, since recapture would be applied at the partner level, all partnerships, including those which have liquidated, would have to supply depreciation information to all their partners.

Finally, the proposal unfairly discriminates against capital-intensive corporations because it would not recapture other tax "preference" items. These preferences include, for example, the expensing of intangible drilling costs and the reporting of income on the installment basis.

LIMITED INTEREST DEDUCTION

Treasury II proposes to restrict interest deductions for individuals by expanding the investment interest limitation under current law. The proposal would subject to limits all nonbusiness interest expense (other than home mortgage interest), a shareholder's portion of S corporation interest expense (except where the shareholder actively participates in management), and a limited partner's share of partnership interest expense. Once fully phased in, the deduction limitation would be $5,000 plus the taxpayer's net investment income. Since the deduction limitation increases as investment income increases, the limitation is more burdensome to wage earners than to individuals with established wealth. This fact was acknowledged by the Treasury Department in testimony before the Senate Finance Committee in 1969 (Limitations on Deductions of Interest, 1969: Hearings on Pub.L. No. 91-172 Before House Ways and Means Comm., 91st Cong., 1st Sess. (1969) (statement of Hon. Edwin S. Cohen, Asst. Sec. of Treas. for Tax Policy)), and would continue to be true under the Treasury II proposal.

One stated purpose of the Treasury II proposal is to prevent "tax arbitrage" -- allowing current interest deductions for debt used to buy property that produces tax-exempt or tax-deferred income (e.g., real estate). However, while the goal of preventing tax arbitrage may be theoretically sound, it is imperfectly executed, because the Treasury II proposal would apply to some, but not all, individuals who invest in businesses partially financed with debt. Specifically, a limited partner's share of partnership interest expense would be subject to the limitation, but a general partner's share would not. Similarly, interest expense incurred by a sole proprietor engaged in a trade or business would not be subject to the limitation.

Treasury II claims that the selective application of its anti-tax arbitrage proposal is meritorious, since limited partners do not actively manage their partnerships. Yet, many general partners are not actively engaged in management, and many sole proprietors employ agents to conduct day-to-day management activities. In fact, Treasury II's distinction seems even less justified when one considers that a limited partner's share of partnership interest expense would be subject to the limitation, even if the limited partner is personally liable for the partnership debt.

The implications of the proposal on an individual's ability to invest in leveraged businesses are clear: wealthy individuals, whose investment income will provide a sufficiently high deduction limitation, or who can purchase leveraged businesses as sole proprietors or invest as general partners, probably would not be affected. On the other hand, middle-income and upper-middle-income individuals, who usually can only afford limited partner status, effectively would be prevented from investing in leveraged businesses because their share of the business' interest costs probably would not be deductible. However, we believe equity requires that interest deductions not be restricted for debt incurred in connection with any trade or business, regardless of the business' form or an investors' status. Thus, under our approach, investors in limited partnerships and general partnerships, and individuals operating as sole proprietorships, would be treated equally.

Further, we believe the deduction limitation may unnecessarily restrict entrepreneurs from starting new ventures. For example, consider the situation of an entrepreneur who wants to start a new business and who borrows money to develop a product. Until that entrepreneur is actually conducting a business, the deduction limitation may prevent the entrepreneur from deducting his/her interest costs. Such a limitation would clearly favor established businesses or wealthy individuals over entrepreneurs who need to borrow.

In addition, for the first time, Treasury II would subject interest expense on debt incurred for noninvestment purposes to an expanded version of the current law, interest deduction restrictions. When Congress was evaluating in 1969 the forerunner of current law, it specifically noted that such a limitation was appropriate in part because investments were controllable expenditures. (Tax Reform Act of 1969, Pub. L. No. 91-172, §221, 83 Stat. 487 (1969); See also H.R. No. 413, 91st Cong., 1st Sess. 1718 (1969), S. Rpt. No. 552, 91st Cong. 1st Sess. 2138 (1969), Conf. Rpt. 782, 91st Cong. 1st Sess. 2414 (1969)). However, the costs of cars, children's college tuition, and medical treatment for infirm family members are, for the most part, uncontrollable, and must be financed due to their magnitude. To be sure, taxpayers with varying degrees of wealth sometimes finance "luxury" purchases knowing that the deductibility of interest provides a partial, indirect government subsidy. However, which purchases are luxury items and which are necessities of modern life is often difficult to determine. In many cases, that determination depends on individual lifestyles and circumstances. Accordingly, in light of the fact that many large, personal expenditures are uncontrollable, and that the limitation is more burdensome to wage earners than to individuals with established wealth, we believe Congress should avoid enacting an overall limitation on an individual's interest deductions from debt used for noninvestment purposes.

Finally, Treasury II could, if enacted, have a severe retroactive effect on many taxpayers, even though it would be phased in over a 10-year period. These taxpayers include individuals who, for example, financed their children's college education relying on the deductibility of interest. Because debt sometimes represents a long-term commitment, Congress should consider permanently grandfathering from the deduction restriction rules any debt incurred prior to the chosen effective date which is not currently subject to the investment interest limitations. That type of effective date was enacted in 1969 for the forerunner of the investment interest limitation under current law. Tax Reform Act of 1969, Pub. L. No. 91-172, §221(b), 83 Stat. 487 (1969).

EXTENDING THE AT-RISK RULES TO REAL ESTATE

In February, 1984, we testified before the Ways and Means Committee in a hearing on tax shelters, accounting abuses, and corporate and securities reforms. At that time, the Committee was considering extending the at-risk rules to real estate.

In our testimony, we first noted that nonrecourse financing was widespread in the real estate industry, and suggested that although the tax policy implications of the proposal were clear, the Committee should also consider the possibility that enactment would cause a temporary lull in construction starts. More likely, we pointed out that application of the at-risk rules may cause extended construction delays as the industry attempted to find other sources of equity capital or awaited increased prices to justify increased risk. For these reasons, we recommended that such a drastic change not be made before carefully considering its economic impact.

We believe our previous comments continue to reflect valid concerns. And, should the proposals be enacted, appropriate transitional rules (e.g., applying the at-risk rules in increasing percentages, such as 10 percent a year) may be appropriate to ameliorate its effects.

TEN-PERCENT DIVIDENDS-PAID DEDUCTION

Treasury II proposes to partially relieve the double taxation of corporations by generally allowing a deduction equal to 10 percent of certain dividends paid. A "Qualified Dividend Account" would be used to ensure that the deduction is attributable to earnings that have borne the regular corporate income tax.

The purpose of the proposal is to somewhat reduce the disparate treatment of corporate debt and equity. Treasury recognizes that a 10 percent dividends-paid deduction is limited relief at best, but it states that the deduction would represent a meaningful step toward reducing double taxation of corporations.

Treasury is rightfully concerned that our major trading partners have partially relieved double taxation of their corporations. However, we believe Treasury II should have proposed a 50 percent dividends-paid deduction, as contained in Treasury I.

Further, we are not sure that the method chosen by Treasury to partially eliminate the debt/equity disparity is the most efficacious, because requiring a Qualified Dividend Account introduces another layer of complexity into a corporate/shareholder tax regime currently overburdened with complexity.

As an alternative to a dividends-paid deduction, we suggest that Congress consider the Deemed Capital Transaction approach. Under this approach, the details of which are attached as an Appendix, all corporate distributions would be treated as long-term capital gain without offset by capital losses and would be subject to an expanded alternative minimum tax.

While not a true integration of corporate/shareholder taxation, The Deemed Capital Transaction approach does partially close the difference in treatment between debt and equity. But more importantly, by eliminating the rate differential on taxation of corporate distributions, massive simplification of Subchapter C could be undertaken.

MEASUREMENT OF INCOME

REPEAL OF BAD DEBT RESERVE METHOD

The Administration's proposal to eliminate the reserve method of accounting for bad debts and limit a taxpayer's deductions in a particular year to the amount of losses specifically charged off runs contrary to the Administration's avowed purpose of fairness. The rationale for allowing the reserve method of accounting for bad debts is to properly match revenue to the expenses (or losses) associated with the earning and taxation of that revenue. This principle has long been a part of tax accounting concepts, where accrual reporting is used.

From a tax policy standpoint, if the recognition of revenue is required before the actual receipt of the cash (i.e., accrual accounting), then it is only fair and proper to allow as a deduction a reasonable estimation of receivables that will never be collected. To do otherwise would result in taxing as income amounts that will never be received and could reasonably be so estimated at the close of an earlier year.

The President's proposal repeals the reserve method for all taxpayers, including financial institutions. While the repeal of some special methods of determining the reserves for financial institutions may have merit, requiring these institutions to use the specific write-off method does not. The reserve method allows financial institutions to reflect more accurately the overall worth of their outstanding loans. Further, at a time when the federal agencies supervising financial institutions have indicated the need for many institutions to increase their loan loss reserves to more properly reflect the financial condition of their loan portfolios, it is ironic that the Treasury would advocate the complete elimination of loan loss reserves for tax purposes.

It has also been our experience that proving the actual worthlessness of a debt for specific write-off purposes is a legal morass of factual circumstances, replete with the prospect for increased taxpayer-IRS litigation. It should also be noted that the effect of the proposal may be to force a lender to drive a financially troubled debtor into bankruptcy as a prerequisite to obtaining a tax deduction, rather than encouraging a work-out solution.

PROPOSAL TO LIMIT THE CASH METHOD OF ACCOUNTING

Treasury II would require taxpayers with gross receipts in excess of $5 million and all other taxpayers issuing accrual method financial statements to owners or creditors to use the accrual method for tax purposes. We oppose this provision as it relates to individual service providers for four reasons. First, the proposal would require certain service providers to pay taxes on accrued income not yet received. However, tax liabilities cannot be paid with accruals; they must be paid with cash. Thus, the proposal departs from a fundamental principle of federal tax policy -- the ability to pay.

Second, the proposal would unfairly discriminate against individuals who join together to provide personal services. Few, if any, individuals operating as sole proprietors have annual receipts in excess of $5 million, and therefore such individuals would not be affected by the proposal. However, a service business owed and operated jointly by several individuals (e.g., in partnership form) is more likely to earn more than $5 million in gross receipts. Businesses whose gross receipts exceed that amount would be required to use the accrual method of accounting for tax purposes, even though _each individual_ participant's share of the business' gross receipts may be no more than a sole proprietor's receipts. Further, gross receipts is not an appropriate measure for applying the proposal to certain businesses, because a taxpayer's gross receipts bears no clear relationship to taxable income. Thus, a highly profitable service business with $4.9 million in gross receipts would not be subject to the proposal, but a marginally-profitable (or loss) business with $5.1 million in gross receipts would be required to use the accrual method for tax purposes.

Third, the proposal is inconsistent, because it would require certain individual service providers to use the accrual method, but would not require similarly situated individuals to do so. For example, almost all employees use the cash method of accounting for tax purposes. This means such an employee would report as income a bonus in the year paid, regardless of whether it was "earned" in a prior year. Further, individuals (and corporate taxpayers) who deal in personal property can elect to use the installment method of accounting for reporting income from sales of their products; but installment sale treatment is not available for the sale of services. Thus, the proposal would allow _some_ individuals to use the cash method for their businesses, but would not allow all individuals to do so.

Fourth, Treasury II states that the cash method of accounting does not clearly reflect income, and that it is subject to manipulation. However, the cash method does clearly reflect income for service businesses because revenues are often not determinable until payment for services are actually received. Further, the Treasury Department has provided no evidence that the cash method has been manipulated by service providers. To the contrary, objective evidence conclusively demonstrates that the cash method does clearly reflect income: partnerships often use it to establish policies regarding partner admissions, withdrawals, and compensation.

INDEXED FIFO AND LIFO CONFORMITY

As a general rule, we support the Administration's proposal for complete repeal of the LIFO conformity requirement. This conformity requirement has provided unnecessary complexity and uncertainty in the area of inventories. Also, the initial reasons for its enactment no longer exist.

When the LIFO inventory provisions were added, LIFO had not been completely embraced by the accounting or tax professions. Thus, before allowing taxpayers to use LIFO for tax purposes, it was decided to include a conformity requirement; that is, a taxpayer must use LIFO for financial reporting purposes to use it for tax purposes. By having the conformity requirement, it was believed that LIFO would only be used when it was clear that LIFO was an acceptable accounting method. However, since the LIFO provisions were initially enacted, LIFO has become a clearly acceptable method of accounting and in many cases a preferable method of accounting for financial reporting purposes. The SEC has also indicated that LIFO is an acceptable accounting method. Thus, the earlier need for LIFO conformity no longer exists.

Also, because of the need to adjust to our changing economy, a number of exceptions have been made to this requirement, adding unnecessary complexity and traps for the unwary. LIFO conformity has forced businesses to make a choice between LIFO and FIFO based on non-tax criteria and has resulted in unfair tax treatment between taxpayers in the same business. The removal of the LIFO conformity requirement would extend the same tax treatment to all taxpayers regardless of their needs or restrictions for financial reporting purposes. Thus, as a general rule, we strongly support repeal of the LIFO conformity requirement. However, we believe consideration of any such legislation should be coordinated with the Financial Accounting Standards Board and the Securities and Exchange Commission concerning the implications for companies which, because of any tax legislation in this area, may desire to switch inventory accounting methods for financial statement purposes.

With regard to indexing FIFO inventories, we question how this method would operate. For any indexing system using outside indices to work, the system itself must be truly simple. Treasury II proposes applying the percentage increase in a price index to the FIFO cost of the number of units in beginning inventory which does not exceed the number of units in ending inventory. The first question that arises is: How are units measured? Many taxpayers have thousands of items in their inventory. If they were required to measure units in terms of specific items, the system would be unworkable.

However, as indicated before, we believe there are significant policy reasons for not extending indexing to additional areas in the tax system. These same considerations may also apply to inventories. Indexing FIFO inventories based on an outside index may not result in an equal tax treatment among all sectors of the economy, and may add further confusion and complexity to an already difficult area.

In the past, LIFO has proven to be an effective method eliminating the effects of inflation on inventories. However, many taxpayers have not adopted LIFO because of its complexity or because of the conformity requirement. As an alternative to indexed FIFO, we suggest that Congress simplify the current rules for using LIFO so that complexity does not prevent taxpayers from using LIFO. For example, in a truly simplified LIFO system, a taxpayer could use the percentage change in the Consumer Price Index (CPI) for its industry as a means of removing inflation from its inventory. Allowing taxpayers to use a broad index such as the CPI, as well as removing the conformity requirement, would greatly simplify the LIFO method and allow most taxpayers to use it. In many cases, taxpayers could also use this simplified LIFO method for financial reporting purposes, thus further simplifying their accounting records by avoiding the need for two separate inventory methods for book and tax purposes.

REQUIRED CAPITALIZATION OF PRODUCTION COSTS

The Administration proposes that certain production costs be capitalized rather than expensed as allowed under current law. Taxpayers would be required to capitalize all costs (both direct and indirect) incident to and necessary for the performance of a particular long-term contract or process, as well as certain other costs. We believe that these new capitalization rules would be unfair, create an undue administrative burden and otherwise defeat the general tax reform goal of simplicity.

Period Vs. Product Costs

The primary argument for the proposed capitalization rules is that they promote a clear matching of revenue and expense for all taxpayers. However, the Administration has failed to consider that the proposed rules distort the basic distinction between period and product costs, and thus do not properly match revenue and expenses. Period costs are those costs that either do not clearly relate to the production of a particular item, or do not benefit future periods. These costs are currently expensed in the period in which they are incurred. Product costs, on the other hand, are those costs directly traceable to a specific product. Such costs are added to the cost basis of the product. Since period costs do not relate directly to the product being produced, but rather represent costs of doing business for the period incurred, such costs must be deducted against revenues from that period to properly match income and expenses.

The Treasury Department recognized this concept in Rev. Rul. 79-25, 1979-1 C.B. 186, wherein it stated that "the exclusion of (certain period) costs from a taxpayer's inventoriable costs will not distort income, except in unusual cases." The current proposal tends to ignore this distinction and attempts to add most period costs to the basis of the product. The Supreme Court, in Comm'r v. Lincoln Savings and Loan Association, 403 U.S. 345 (1971), also addressed the concept of cost benefitting future periods. The court recognized the importance of this distinction when it said that "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year." While the cost involved in Lincoln Savings and Loan Association, supra, did not involve inventory, the principle is the same; that is, the expense must create or add to a separate and distinct identifiable asset. Period costs do not meet this test. Thus, rather than providing a true matching as Treasury II suggests, the capitalization of these costs would not provide proper matching.

Besides not providing proper matching, the proposal would create a significant administrative burden on taxpayers since many of the costs included in the proposal would be very difficult to allocate to a specific product or project. This problem is inherent in period costs and is another reason why period costs are currently expensed. An example of this is the allocation of administrative salaries. There is no natural basis on which to allocate these expenses. To ameliorate the allocation problem, regulations would have to be drafted to set forth specific guidelines. However, given the vagueness of the proposal itself, any regulations that are drafted could easily become more burdensome and costly. Such administrative difficulties could present an unfair burden to, and add unnecessary complexities for, taxpayers.

Furthermore, two sets of records would be required to keep track of inventories. A prime example of the potential dual recordkeeping burden would be in the LIFO area where extensive and complex calculations are required. Deviations from current financial statement methods and presentation likely would not be readily permitted by the Securities and Exchange Commission or condoned by the Financial Accounting Standards Board despite tax law revisions.

Capitalization of Interest

Other complexities and unfairness may exist with respect to capitalization of interest expense. For example, interest expense may reflect the cost of raising working capital. Although interest may arise due to the financing of one contract, it is likely, especially with smaller businesses, that the loan proceeds will be used wherever needed in the business.

Capitalization of interest would also create undue complexities. Taxpayers who make progress payments or advance payments to contractors would be required to capitalize, as construction period interest, interest attributable to such payments but only in certain instances. If this is an indication of the Administration's approach to the capitalization rules, they will lead to increased complexity instead of simplification.

INTERNATIONAL TAXATION

The Treasury II proposal would dramatically change the tax treatment of U.S. companies conducting business outside of the continental United States. In particular, the proposed changes relating to the treatment of companies operating in U.S. possessions, the foreign tax credit limitation, the source of income rules and the allocation of research and development expenses would substantially increase the cost of doing business abroad. Since multinationals from other foreign countries are not subject to such onerous and costly provisions, we are concerned that U.S. companies may be at a competitive disadvantage, ultimately resulting in the loss of U.S. jobs and an increase in the U.S. trade deficit. Moreover, the proposed rules would increase the complexity of some of the most difficult provisions currently existing in the Internal Revenue Code. We question whether the conceptual underpinnings advanced in support of these proposals can justify the increased costs and complexities to U.S. businesses.

POSSESSIONS CREDIT

With regard to the Puerto Rico and Possession Tax Credit, the proposal would repeal the present 100% credit and dividend received deduction for qualified business and investment income from Puerto Rico and other U.S. possessions. The comparable benefit for corporations engaged in business in the Virgin Islands would also be eliminated. The proposal would replace this income-based credit with a new wage-based credit. This change would have the effect of increasing the U.S. tax on possessions operations in most instances and would eliminate any U.S. tax benefits for earning possessions source investment income. A grandfather clause would preserve the present income-based credit for existing products for five years if the wage credit is not elected.

We believe this proposal is based on a faulty analysis of the possessions credit's effect on the Puerto Rican economy in general and employment in particular. This analysis overemphasizes the absolute dollar value of the tax benefit accruing to certain large companies and does not adequately take into account the interests and concerns of the broader Section 936 community. In addition, the analysis does not take into account the indirect benefits that ripple through the Puerto Rican economy resulting from the operations of Section 936 businesses.

Most studies involving Section 936 are based on empirical data relating to years prior to adoption of the Section 936(h) provisions requiring allocation of income to manufacturing intangibles. Although the proposals indicate that, based on a preliminary analysis of 1983 returns, there has been no reduction in tax benefits per worker compared to prior years, it is highly unlikely given the short history of Section 936(h) that adequate time has elapsed to accurately support such a conclusion. Thus, we believe it is premature to consider any further cut-back in the Section 936 incentive program.

Finally, the analysis and studies of the current Section 936 tax incentive potentially overstate the anticipated revenue gain that could be realized in converting to a wage-based credit. This overstatement is due in large part to the assumption that existing operations in the possessions would be subject to current U.S. taxation upon repeal of the income-based credit. In fact, many companies currently operating in the possessions would eventually remove their operations to foreign jurisdictions where significant tax benefits are offered. The earnings from these foreign-based operations generally would not be subject to current U.S. taxation but rather would be eligible for indefinite deferral. Moreover, companies that develop their intangibles associated with these operations overseas or that have already transferred their intangibles overseas would not be subject to any significant U.S. taxes on the transfer of their possessions operations abroad. Thus, at least in the near term, the revenue gain from a change to the wage-based credit would not be nearly as significant as the Treasury Department estimates.

It is also important to recognize that Puerto Rico has made significant gains in economic growth and in the development of its infrastructure. This was accomplished only through a strong tax incentive program. Any significant tampering with Section 936 will have serious adverse consequences for the Puerto Rican economy and its people. Naturally, if this should occur, the Treasury would lose revenue from its increased welfare obligations and the like.

In light of the foregoing concerns, we recommend that any consideration of repealing the possessions credit be delayed until adequate statistics can be developed on the impact of the new (post-TEFRA) rules for intangible income. In any case, proposals for repeal should be postponed pending completion of studies which adequately establish the extent to which anticipated increases in tax revenues will be offset by increased costs of providing economic assistance to Puerto Rico.

In addition, the five year grandfather clause for the existing credit is insufficient. Investment and business decisions with respect to existing products have been made on the premise that the credit would be indefinite. Even after the actual cost of investment has been recovered, there would be additional costs and burdens associated with relocating existing operations for many companies. Therefore, the grandfather clause should be made permanent as to existing products for which a valid Section 936 election was in effect for the taxable year beginning prior to the date of enactment.

Rather than the wage-based credit being mutually exclusive of the grandfather clause for the income-based credit on a per-corporation or broader related-group basis, taxpayers should be allowed to elect the wage-based credit for grandfathered products on a product-by-product basis. Otherwise, companies under the grandfather rules will have no incentive to manufacture new products in the possessions.

Finally, where the wage credit is elected, there should be a foreign tax credit for any possessions taxes. The wage credit provides an incentive for hiring possessions employees while the foreign tax credit avoids double taxation on a corporation's income. Unlike the income-based credit, the two provisions should not be mutually exclusive.

PER-COUNTRY LIMITATION ON FOREIGN TAX CREDIT

The proposal to switch to a per-country limitation from an overall limitation is based on the premise that the foreign tax credit limitation should, in an ideal world, limit the credit for foreign taxes on a transaction by transaction basis. On a more practical level, this result can be approximated by limiting the credit on a per-country basis. We disagree with this premise on conceptual and tax policy bases, and question whether the anticipated increase in tax revenues can justify the additional complexities accompanying the proposed per-country limitation.

Under the current overall limitation, the operations of a U.S. taxpayer outside of the United States are viewed generally as a whole and separate from the taxpayer's U.S. operations. In general, the foreign taxes paid by the taxpayer are averaged over the sum of the taxpayer's foreign earnings. In this manner, the taxpayer's foreign source income is not subject to double taxation. At the same time, the taxpayer is subject to residual U.S. taxation to the extent foreign taxes on total foreign earnings do not exceed U.S. taxes computed as if the United States had original taxing jurisdiction over that income.

The per-country limitation subdivides this taxing scheme into separate baskets for each country in which the taxpayer operates. Although this separation more closely approximates a separate-transactions, foreign-tax-credit limitation, we feel the limitation better functions when it preserves U.S. residual taxation on a taxpayer's foreign earnings taken as a whole, as under the overall limitation. The overall method more closely approximates the various methods used by many foreign countries and is much simpler than the per-country method. For example, many foreign countries exempt income derived outside of their borders. This system has been rejected by the United States because U.S. taxpayers are subject to taxation on their worldwide income. However, the integrity of this principle is fully maintained under the overall limitation. Moreover, by treating a U.S. taxpayer's foreign income as if from a single source, the overall limitation more closely resembles the territorial systems of our trading partners. The per-country limitation, on the other hand, would raise the tax cost of operating outside of the United States and would, thereby, seriously impede the ability of U.S. companies to compete in many high-tax foreign countries.

The second major disadvantage of the proposed per-country limitation is its increased complexities and record-keeping requirements. Taxpayers would have to calculate a separate foreign tax credit limitation for each country in which their income is sourced. In the case of dividends from foreign subsidiaries, tracing dividends through multiple tiers of corporations may be required. In addition, extensive calculations would be necessary to determine whether to resource foreign taxes, as would be allowed under the proposal. Elaborate bookkeeping would further complicate an already complex area of the Code.

In conclusion, we believe the foreign earnings of U.S. taxpayers should be viewed as a whole and not on a per-country basis for purposes of avoiding double taxation. Past practices unrelated to business considerations, whereby taxpayers increased their limitation, have been largely eliminated by changes made in the past few years, especially the enactment of the 1984 Deficit Reduction Act. In addition, we believe the additional revenue that might result from a per-country limitation would not justify the additional administrative cost to taxpayers and the IRS.

OTHER FOREIGN TAX CREDIT MATTERS

Carryforward and Election Rules

We endorse the proposal that would extend the carryforward from five to ten years, and the proposal that would permit an election to credit or deduct foreign taxes on a per-country basis. However, in the interest of consistency, the carryover period should be three years back and 15 years forward, as for other business credits. In addition, taxpayers should be allowed to deduct all excess foreign tax credits. This is especially critical for U.S. contractors and other service providers who are subject to foreign taxes on work performed in the U.S. for customers and clients located in foreign countries.

Research and Development Expenses

The current moratorium on apportionment of U.S. R&D expenses to foreign source income for purposes of the foreign tax credit limitation will expire after 1985. Although the proposal recommends extending the R&D credit (which will also expire after 1985) for three more years, there is no mention of whether the R&D moratorium for foreign tax credits would be continued. Apportionment of R&D expenses to foreign source income has been justified on the basis that R&D generally contributes to the profitability of foreign operations. However, to the extent apportioned R&D would generate excess foreign tax credits, the result would be the same as though there were no deductions for R&D. Since R&D is a more discretionary expenditure than foreign taxes, the effect of apportioning R&D expenses to foreign sources would be to discourage corporations with excess foreign tax credits from making R&D expenditures. Accordingly, we recommend the moratorium be made permanent, or at least extended for the same period as provided for the R&D credit.

Sourcing of Royalties

The proposal would continue the existing rule that royalties from related foreign licensees and sales of intangibles for use abroad generate foreign source income. This proposal is premised on the fact that such licenses and sales are usually motivated by non-tax, business considerations. For the same reasons that support these proposals, we recommend that Treasury II also specifically provide that royalties from unrelated licensees for use of intangibles abroad continue to generate foreign source income.

Depreciation of Foreign Assets

The proposals would require use of the more conservative RCRS rules of Treasury I in depreciating assets of foreign branches and subsidiaries. This requirement would follow the existing practice of allowing less liberal depreciation benefits for assets used abroad. If adopted, this proposal would result in complexity beyond domestic book/tax differences because foreign tax authorities may require depreciation based on a third set of rules. In the absence of a clear purpose to discourage investment abroad in depreciable assets, foreign assets should be depreciable on a book basis, or on whatever basis is permissible for domestic assets.

FOREIGN EXCHANGE

The proposals would resolve many unclear issues and codify certain rules developed through case law and IRS rulings. The proposals are based on a 1980 Treasury study which generally conforms with the foreign exchange rules of FASB Statement 52. We support the approach of the proposals and would welcome the certainty it would provide. However, we believe several of the proposed rules should be modified.

First, under the proposals the foreign currency books of foreign branches would be translated only under the profit and loss method. This generally follows FASB Statement 52, except that FASB takes account of unrealized exchange gains and losses for inflationary currencies. Taxpayers should be allowed to take account of unrealized exchange gains and losses where such action is required by FASB Statement 52.

Second, the proposals would reconcile the differences between dollar and foreign currency interest rates by requiring amortization of the difference between certain financial assets and liabilities, such as trade receivables and payables, debt instruments and preferred stock. To avoid unnecessary complexity, we recommend the amortization rules should apply only where the transaction exceeds a minimum dollar amount.

Third, gain or loss on forward contracts hedging the principal amount of business related foreign currency assets and liabilities would be treated as adjustments to interest income or expense on an accrual or mark-to-market basis. We support this approach and recommend that it be extended to forward contracts which hedge the net asset or net liability position of foreign subsidiaries. This would be consistent with the rules for hedging net asset positions of foreign branches whose books are maintained in foreign currency.

Fourth, with regard to regular dividends from foreign subsidiaries, we believe there should be consistent application of the rules for translating foreign currency in calculating the amount of a distribution treated as a dividend, and all terms in the deemed paid foreign tax credit formula. Dividends from foreign subsidiaries frequently represent accumulated earnings and profits for several years and it could be difficult to translate these profits on an historical basis. Similar problems would arise in translating accumulated profits, which are proposed to be determined on an aggregate basis, unlike the current year-by-year approach. Thus, we endorse the proposed retention of the Bon Ami rule, under which the deemed paid tax formula is translated at the date of the dividend.

With regard to deemed dividends under Subpart F and from investments in U.S. property, we support using the average rate of exchange for the year in translating foreign taxes in the deemed paid credit calculation. This is consistent with the new rules for eliminating unrealized exchange gains and losses in calculating Subpart F income. Moreover, it is sensible because, unlike the treatment of actual dividends that might be distributed from several years' earnings, deemed dividends under Subpart F are limited to the current earnings and profits of the subsidiary.

Finally, for purposes of Section 1248, we recommend that earnings and foreign taxes be translated at the date of the transaction which triggers the application of Section 1248.

RETIREMENT SAVINGS

Many years ago Congress recognized the need for individuals to have special tax treatment to foster retirement income. As a result, tax policies were developed to encourage private retirement plans. And, they worked. Now, given the state of the Social Security system, a strong private retirement system is more important than ever. The tax system, therefore, should encourage the continuation and further development of private retirement plans.

Some of the proposed changes, such as the increase in the spousal IRA to $2,000, would encourage savings for retirement. We support these changes.

On the other hand, many of the proposed changes will adversely affect the private retirement system. Instead of simplification, many of the proposals further complicate an already confusing area. Instead of reducing administrative burdens, some of the proposals will result in increased administrative burdens and costs. These proposed changes will only serve to discourage employers from establishing or continuing to use these plans. In fact, many of the proposals will make plans less popular even among employees, thereby decreasing participation levels.

REVISE CASH OR DEFERRED ARRANGEMENT (CODA OR SECTION 401(k))

The proposal would make many changes in the CODA provisions. On the whole, these changes make the CODA rules more complicated, increase administrative burdens, and make the plans less desirable from a participant's perspective.

Limit Employee's Elective Contribution to $8,000 Reduced by IRA Contributions

As a general rule, this proposal would limit an employee's elective 401(k) contribution to $8,000 per year. However, this amount would be reduced by deductible IRA contributions made by the individual. We see a number of problems with these limitations.

First, the $8,000 nonindexed contribution limit is not consistent with the general philosophy of the Employee Retirement Income Security Act of 1974 (ERISA). For individuals entering the plan late in their careers, the $8,000 limit does not provide an adequate savings opportunity. This is especially true if the $8,000 amount is further reduced by the individual's IRA contributions. If a CODA is to serve as a retirement savings vehicle, the limit needs to be realistic. But, how does one arrive at a realistic limit? We suggest this be done by using the limitations we currently have in the Code. Although a CODA is not a traditional profit-sharing plan, it is an employer-sponsored plan and should be compared with other employer-sponsored plans, not with IRAs. CODAs, therefore, should be subjected to the same limitations as other profit-sharing plans, i.e., annual additions of the lesser of $30,000 or 25 percent of compensation.

Second, reducing the 401(k) limit by IRA contributions will create an administrative nightmare. It requires the integration of an individual plan with a corporate plan. This means plan sponsors will need to obtain information on how much and when each employee is contributing to an IRA. However, many IRA contributions are often made after the end of the year while contributions to 401(k) plans are made during the year. As a result, in most situations, it will be impossible for employers to timely determine what the appropriate 401(k) contribution limit is.

Third, the reduction for IRA contributions is contrary to a policy of encouraging retirement savings. Prior to 1982, IRA deductions were not allowed for individuals who were participants in an employer-sponsored plan. In 1981, Congress was concerned that the resources available to individuals at retirement were not adequate to prevent a decrease in an employee's standard of living after retirement. To help meet these needs, the Economic Recovery Tax Act of 1981 extended IRA eligibility to individuals who participate in employer-sponsored plans. The extension was designed to promote greater retirement security.

The need for private retirement savings is greater now than ever. Therefore, a policy of encouraging retirement savings should be continued. Individuals should be able to contribute up to the limits of other employer-sponsored plans. Also, CODA contributions should not be offset by IRA contributions. Doing so only discourages retirement savings.

If a reduction is deemed appropriate, however, it should not be to the 401(k) limit. Instead, IRA contributions should be reduced by amounts an employee contributes to a 401(k). At least this would be much simpler administratively, and it would remove a substantial burden from the employer.

Modify Actual Deferral Percentage Test (ADP)

The proposal would modify the ADP test for CODAs in a number of ways. The purpose of modifying the ADP test is to reduce the disparity permitted between elective contributions by highly compensated employees and other eligible employees. We agree with the intention, but do not believe the proposed changes will accomplish their intended purpose. Instead of expanding rank-and-file coverage, employers may decide not to offer 401(k) plans at all.

Because the proposed changes are extremely complicated, the administrative responsibilities would be increased, and the costs associated with them would be high. It is conceivable that employers might decide not to sponsor a plan simply because the costs associated with doing so are too excessive. This would harm everyone including lower-compensated employees, and would be contrary to the policy of encouraging employer-sponsored plans.

To reduce the disparity, we suggest that Congress retain the portion of the proposal which reduces the amount by which the higher-compensated employees may contribute relative to the contributions made by the rank-and-file employees. This change would accomplish the stated purpose of reducing the disparity between contribution levels without increasing the administrative burden on the employer.

Eligibility Required After One Year of Service

The proposal would require that employees complete one year service to be eligible to participate in a CODA . The proposed change adds another exception to the general eligibility rules. This just serves to add complexity to the rules. A 401(k) plan is a type of employer-sponsored qualified plan. The eligibility rules applicable to other employer-sponsored qualified plans should apply to 401(k) plans too.

Modify 401(k) Withdrawal Restrictions

The proposal would modify the in-service withdrawal restriction by no longer allowing distributions on account of hardship. Although allowing hardship withdrawals is contrary to the principal purpose of a 401(k) plan, which is to provide retirement savings, our experience is that hardship withdrawals are necessary to encourage participation in these plans.

One of the most important features of a CODA is the ability of participants to have access to their funds. Lower-paid and younger employees need access to the money to pay unexpected medical expenses, to purchase a home or to pay a child's college tuition. If they do not have access to these funds they may not participate. Thus, eliminating the hardship withdrawal provision may result in a decrease in participation in 401(k) plans by rank-and-file employees.

MODIFY LOAN RULES

The proposal would make two major changes in the retirement plan loan rules.

Reduce $50,000 Limit

The $50,000 limit would be reduced by the highest outstanding loan balance owed by the employee to the plan during the prior twelve months.

Changing the $50,000 limit results in an unnecessary complexity. The rule as it applies now is very simple. We understand Treasury's concern that employees may effectively maintain a permanent outstanding $50,000 loan balance through the use of a balloon repayment obligation. It is a valid concern. But, this problem could be solved by requiring a reasonable repayment schedule instead of solely requiring a loan be repaid within five years, especially since ERISA already contains sufficient safeguards and permits loans only if certain requirements are met. For example, as a general rule, any loan must bear a reasonable rate of interest, be adequately secured, and be available on a nondiscriminatory basis. By requiring a reasonable repayment schedule, the plan administrator would be responsible for ensuring that loan repayments are made according to a reasonable schedule.

Modify Special Rule for Home Loans

The exception to the five-year repayment period would be limited to loans for the first purchase of a principal residence by and for the employee. We agree that the extended pay-back period should be limited to use by, and for the benefit of, the participant. However, the rule should not be limited to the purchase of a first principal residence.

The current loan provisions were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Loans were permitted because Congress was concerned that an absolute prohibition on loans would discourage retirement savings by rank-and-file employees who may need access to such money for emergencies. Therefore, loans which would not substantially diminish an employee's retirement savings were permitted.

The concern Congress expressed with respect to participation of rank-and-file employees applies to homeowners. People who currently own a home may not participate in a plan if they cannot borrow money, with an extended repayment schedule, to purchase a home to meet expanding family needs or upon transferring to a new city. The extended repayment period is needed in these situations as much as it is needed for the first-time purchase of a home. Further, there are already safeguards to prevent loans from being abusive. For example, the participant does not have unlimited access to the money, and there are limits on the loan amount as well as other ERISA safeguards. If a loan is taken to purchase any home, a payback period consistent with conventional mortgages should be allowed. Thus, we believe the reasonable period exception should apply to any loan used to acquire, construct, reconstruct, or substantially rehabilitate any dwelling unit which is used by the participant as a principal residence.

UNIFY DISTRIBUTION RULES

Recapture Tax on Early Distributions

The proposal would impose a 20 percent excise tax on a distribution made before the individual's death, disability, or attainment of age 59 1/2. If the early distribution is used to pay for college expenses of a dependent, for the purchase of the individual's first principal residence, or to replace certain unemployment benefits, the rate of the recapture tax would be reduced to 10 percent.

We agree that the current law sanction of plan disqualification is too onerous for violation of the minimum distribution rules. Since the purpose of employer-sponsored plans is to provide for retirement savings, we also agree that a sanction should be imposed on early withdrawals. We believe, however, that a 20 percent excise tax is too severe, and that a tax of 10 percent would be sufficient. Further, there are situations where people legitimately need the money due to hardship. In such a situation, they should be allowed to withdraw money without having to pay an excise tax. Clear guidance should be provided by statute as to what circumstances will be deemed to constitute such a hardship. As mentioned, hardship withdrawals are especially important in 401(k) plans since young employees and rank-and-file employees will be hesitant to participate if they perceive they do not have access to the money in an emergency.

Another problem with the early withdrawal proposal is the way it handles individuals retiring before age 59 1/2. Under the proposal, a distribution before the attainment of age 59 1/2 would be an "early distribution" only if it was, for example, a lump sum distribution, and would not be treated as an early distribution if it is one of a scheduled series of substantially level payments under a single or joint life annuity or under a term certain of at least 180 months commencing upon retirement under the plan. This provision is not needed, and just adds complexity. The reason for the early distribution rules is to keep the money in the plan until retirement. A person retiring prior to age 59 1/2 is retiring nonetheless and should have access to the money.

REVISED RULES FOR LEVERAGED ESOPS

Deduction Rules

An employer with 15 or more employees that borrows funds to purchase outstanding employer securities would be permitted under Treasury II to deduct principal payments each year made with respect to the indebtedness, provided the loan is amortized at a certain rate. The principal payments would only be deductible each year up to 25 percent of the compensation of employees who are eligible to participate in the ESOP. This new rule would replace the current special deduction limits for Leveraged ESOPs. In addition, the special exception to the prohibited transaction rules for Leveraged ESOPs would be repealed.

The clear intention of this proposal is appropriate: to simplify some of the rules involving Leveraged ESOPs. However, it complicates the existence of very small ESOPs (i.e., less than 15 employees) by prohibiting leveraging. If ESOPs are to encourage employees to perform well, there is no reason employees in small companies should not be permitted the same incentives allowed to employees in larger companies.

In addition, the proposal creates disparate treatment for the acquisition of stock through corporate borrowing and the acquisition of stock from, for example, a shareholder through an installment sale. In the first case, the principal payments are deductible and in the second case they are not. Thus, the proposed rules would be more complicated.

Distribution Rules and Voting of Unallocated Securities

Annually, stock held by the ESOP would be required under Treasury II to be distributed in proportion to the scheduled principal repayments for the year. Distribution of dividends on such stock would also be required. In addition, employees who participate in the ESOP would be permitted to vote stock that has not yet been allocated to their accounts, but only with respect to corporate matters involving more than a majority vote.

According to the Treasury II analysis, the purpose of these provisions is to permit employees to be fully capable of exercising all the rights of direct stock ownership, including the right to vote, receive dividends, and to determine whether to dispose of employer securities. According to the analysis, vesting the right to vote in a third party, such as a trustee, deprives the employees of a valuable right of stock ownership.

While employees may have more incentive to perform well if incidents of ownership in the stock is vested in them, we believe this, to a large extent, has been accomplished through previous tax bills. The right to receive dividends on stock allocated to their accounts in an ESOP was given to employees under the Deficit Reduction Act ("DRA") of 1984. However, under DRA, the dividends need be passed through to the participants only if the employer intends to deduct them. However, this action does not require the distribution of the stock (which, for reasons discussed below, we do not believe is advisable). If Congress believes it is essential, the distribution of the dividends could be made mandatory.

The right to vote the shares allocated to their accounts is provided to employees of publicly traded companies by Section 409(e). This too is accomplished without distributing the securities. Thus, similar language could be provided to enable employees of privately held companies to vote the allocated shares without requiring that the shares be distributed.

With respect to the unallocated shares, Treasury II displays a lack of awareness of the fiduciary responsibility provisions of ERISA which require a trustee to act in the best interests of participants and beneficiaries. Since ERISA Section 404(a)(1)(A) requires such behavior of trustees, there seems to be no need for a rule requiring employees to be allowed to vote unallocated securities if the sole purpose for that rule is, as is stated in the analysis of Treasury II, to protect employees.

Further, the distribution of employer stock to employees and the proposal that such employees would realize no income on the distribution until the stock was sold, provides disparate treatment for employees depending on whether their employers sponsor a Leveraged ESOP, a nonleveraged ESOP, or, for example, a profit-sharing plan that invests in employer stock. If the reason for this disparate treatment is that the Leveraged ESOP is not intended to be a retirement plan, as suggested in the proposals, there does not seem to be a logical reason for limiting the deduction for principal payments to 25 percent of compensation -- a requirement that is carried over from the current special deduction rules for Leveraged ESOPs (Section 404(a)(9)). If changes are made to the Leveraged ESOP provisions, a consensus should be reached on whether the plans are for retirement or not. If the plans are to be merely incentive compensation arrangements, the applicable rules for incentive compensation should apply, not a combination of qualified plan rules and incentive compensation rules.

Also, the proposals will result in the application of different rules with respect to the leveraged and the nonleveraged shares in an ESOP. This could result in an employee receiving some stock from an ESOP to the extent the ESOP is leveraged, but not receiving (or voting) other shares because no debt was incurred to purchase such shares. Determining which shares are subject to what requirements and what requirements are applicable to other shares will impose a significant administrative burden on employers and employees.

INDIVIDUALS

REPEAL OF STATE AND LOCAL TAXES DEDUCTION

Treasury II proposes to eliminate deductions for all itemized state and local taxes paid by individuals. For the reasons discussed below, we strongly oppose eliminating the deduction for state and local income taxes. We do not oppose the proposal with respect to the deduction of other state and local taxes that are not related to a trade or business, or investment income.

When evaluating the President's proposal with respect to income taxes, we believe Congress should consider the inherent unfairness it would create. This unfairness would exist because income taxes are as much a cost of earning income as other expenses which would continue to be deductible under Treasury II. For example:

- Under current law, an employee is allowed to deduct unreimbursed business expenses. Under Treasury II, such expenses would continue to be deductible, albeit subject to a "floor."
- Under current law, an investor can fully deduct non-trade or business expenses incurred to earn investment income. Even Treasury II would continue to allow these deductions subject to a "floor."

- Employers are allowed under current law to deduct all ordinary and necessary business expenses including state income taxes, regardless of whether such expenses are "controllable."

Thus, even under Treasury II, many expenses associated with earning income would be deductible. Yet, Treasury II would disallow deductions for state and local income taxes, even though such taxes are directly related to income earned. As a matter of tax policy, we question the fairness of this distinction.

Further, we believe Congress should be aware of the potential problems non-deductibility of individual taxes may cause state and local governments. It it seems highly unlikely that enactment of the Treasury II proposal would cause individual taxes to decline, but, there would be pressure on state and local governments to impose new taxes on business, since business taxes would continue to be deductible. We question whether this effect is desirable. However, continuing the deduction for individual income taxes would provide state and local governments greater latitude in deciding whether future tax increases should be borne by individuals or business. And, maintaining the deduction for income taxes may discourage state and local governments from imposing regressive sales taxes, whereas income taxes, usually progressive, are generally accepted as fairer.

In support of the proposal, three primary arguments are raised:

- The federal tax benefit of the deduction is unfairly distributed.
- Individuals receive substantial personal benefits from paying state and local taxes.
- The deduction provides an inefficient federal subsidy to state and local governments.

Some of the following points have broad applicability to all state and local taxes, and therefore should be considered when evaluating the entire proposal. However, our comments are directed to the proposal as it relates to deductions for state and local income taxes.

Disproportionate Benefits

Treasury II states that the deduction for state and local taxes results in residents of low tax states subsidizing high income residents of high tax states. Assuming this assertion is supportable, it is important to recognize that residents of high marginal rate income tax states may also subsidize residents of low tax states by other means. Also, some high tax states argue that their residents pay a disproportionate amount of federal income taxes in relation to the federal benefits received by those same residents. While we have not made any detailed analysis of this point, we urge that you apply a broad perspective on this issue, one which is consistent with fundamental principles of federalism.

Substantial Private Benefits

Treasury II also claims that state and local taxes provide individuals with substantial private benefits, such as public education, water and sewer services, and garbage collection. For this reason, Treasury II analogizes state and local tax payments to controllable, individual decisions concerning how much to spend on private goods. According to Treasury II, such decisions can be controlled through the electoral process or by relocating in another jurisdiction.

However, with respect to income taxes, Treasury's current statements in Treasury II are inconsistent with a 1977 Treasury Department study that found:

> The payments to (a State government) are (not) good proxies for the value of services received. For that reason there is a strong equity case for allowing a deduction of such payments in calculating individual income. . . These (income tax) payments reduce the resources available to the payor for consumption or accumulation, and hence they are properly deductible. Blueprints For Basic Tax Reform, Dept. Treas., Jan. 17, 1977, pp. 92, 93.

A similar conclusion was reached by the Congressional Research Service in a 1983 study conducted for the Subcommittee on Intergovernmental Affairs. Cong. Res. Ser., Libr. Cong., 98th Cong., 1st Sess., Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects, 77 Comm. Print, at 29 (1983).

Further, the level of state and local expenditures is -- like federal government expenditures -- often uncontrollable, and therefore not subject to change through the electoral process. As for the "relocation" argument, it is valid only in theory, since many individuals effectively are prevented from relocating to low tax jurisdictions by reason of employment, economic, family, or other similar circumstances.

In addition, it seems incongruous to allege that the receipt of "private benefits" are grounds for eliminating the state and local income tax deduction, while similar benefits are derived from income taxes paid to foreign jurisdictions for which a credit remains available under Treasury II.

Inefficient Federal Subsidy

Treasury II claims that the deduction provides an inefficient federal subsidy to state and local governments. However, the argument is irrelevant since, according to a 1983 Congressional Research Service study, the probable purpose of the deduction was not to provide a subsidy. Cong. Res. Ser., Lib. Cong., supra at 23-24. Rather, the study states that the deduction has probably been allowed since enactment of the first individual income tax in 1913 to avoid imposing a "tax on a tax." That is, Congress has recognized for over seventy years that it is inappropriate to tax income over which the taxpayer has little or no discretionary control.

ONE-PERCENT TEST FOR MISCELLANEOUS ITEMIZED DEDUCTIONS

In certain circumstances, individuals can deduct under Sections 162 and 212 unreimbursed employee business expenses, miscellaneous itemized deductions, and certain state and local taxes. These expenses typically include education costs to improve job skills, union dues, job-related clothing costs, and investment expenses.

Treasury II would restrict certain Section 162 and most Section 212 deductions by allowing a deduction only to the extent those expenses exceed one percent of an individual's adjusted gross income. According to Treasury II, the one-percent "floor" would simplify recordkeeping, reduce taxpayer errors, and ease IRS administrative burdens, while still allowing deductions for taxpayers who incur high amounts of such expenses.

Historically, employees have been allowed to deduct under Section 162 unreimbursed expenses directly related to earning their salaries. Congressional concern with taxing gross earnings was underscored when, in 1942, the forerunner of Section 212 was enacted in response to the inequity of taxing investment income while not allowing deductions for expenses directly related to earning that income. (Pub. L. No. 753, Ch. 619, §121, 56 Stat. 819 (1942). See H.R. Rep. No. 2333, 77th Cong., 1st Sess. 46 (1942)). In light of these purposes, we believe the effect of Treasury II would be to improperly tax many individuals on their gross salary or investment income instead of their net earnings from such sources.

Further, the proposal would unfairly treat certain employees differently, depending on their employers' policies. For example, assume one hospital provides its nurses with uniforms (a nontaxable benefit under Section 132) while another hospital does not. Also assume the first hospital pays its nurses $290 per week, while the second hospital pays its nurses $300 per week. The $10 per week salary differential reflects the cost of buying and maintaining uniforms. Under current law, nurses working for the second hospital would effectively be taxed on $290 per week, since the cost of their uniforms would be deductible (assuming they itemize). Thus, nurses in both hospitals would be taxed on $290 per week under current law, even though their employers' policies differ. However, under Treasury II, the nurses who provide their own uniforms would probably be taxed on at least $293 per week ($10 minus one percent of $300), because they would lose a deduction amounting to one percent of their salary for the costs of their uniforms (or the full $10 if they did not exceed the floor amount for all such deductions).

Further, we question whether the proposal would simplify the tax system. Individuals would still be required to decide what expenses, if any, may be deductible. In addition, individual taxpayers would then need to compute a modified adjusted gross income. If the total of those expenses exceed one percent of the preliminary adjusted gross income amount, the excess would be deductible in arriving at an individual's actual adjusted gross income. It is doubtful that this proposal simplifies the existing system, which allows the expenses to be reported as an adjustment to gross income or as an itemized deduction. Thus, the proposal would increase the compliance costs for many taxpayers. For these reasons, it is questionable whether the objectives of fairness and simplicity will be accomplished by the proposed one-percent floor on these deductions.

CONCLUSION

These hearings play a critical role in the tax reform process. Our comments are made with an awareness of both the necessity for and the limitations of tax reform. Ernst & Whinney remains dedicated to tax reform. In this spirit, however, we are striving for the best form of tax reform -- one that is equitable for all taxpayers, avoids unnecessary complexity, and strives to minimize the effects of transition.

Statement of

Robert O. Aders

In Behalf of

The Food Marketing Institute

Presented to

Committee on Finance

United States Senate

Washington, D. C.

October 2, 1985

Mr. Chairman and Members of the Committee:

My name is Robert O. Aders. I am President and Chief Executive Officer of the Food Marketing Institute (FMI) and am pleased to present this statement in behalf of FMI on tax reform and simplification.

The Food Marketing Institute (FMI) is a non-profit association that conducts programs in research, education and public affairs on behalf of its 1,500 members -- food retailers and wholesalers. FMI's domestic member companies operate over 17,000 retail food stores with a combined annual sales volume of $140 billion -- half of all grocery sales in the United States. More than three-fourths of FMI's membership is composed of independent supermarket operations or small regional firms.

FMI strongly supports thorough and fundamental restructuring of the federal income tax system, both individual and corporate. We commend President Reagan for his leadership in making this an objective of highest priority and in taking this issue to the country. Special attention is due Secretary Baker, former Secretary Regan, and the Treasury Department for their invaluable work in "Treasury I" and on the President's proposal. In a letter to the President on December 17, 1984, FMI was probably the first trade association to take an affirmative public position in support of the basic objectives and central thrust of reform set forth in Treasury I. We repeat that support today for the President's proposal, if it is retained intact as originally proposed, although we would still prefer the Treasury I approach.

We recognize that the tax writing Committee will develop their own approaches as the tax legislative process unfolds, and that many changes in pending proposals will be considered. Our purpose today is to bring briefly to your attention several matters of particular concern to the food marketing industry which we urge you to bear in mind as you proceed to develop this important legislation.

Before we move to specific issues, however, we feel that several general observations are in order.

FMI believes the time for a real restructuring of our income tax system is at hand. It would be highly unfortunate if the Congress failed to avail itself of this opportunity. The existing system in many respects is becoming intolerable, both for individuals and for business. The tax base in both cases has been unduly narrowed, and many have proposed use of the system for a long list of social, economic or other purposes. Many of these proposals may have been justifiable when made, but due to the proliferation, which continues year by year, and the use of all those special provisions in combination with one another, the base has been so narrowed that rates are higher than necessary and economic decisions are drastically distorted.

Industries and companies with approximately equal economic incomes are treated differently under the present tax system. Some pay no taxes; some actually have negative rates; others therefore have to pay high effective tax rates. The food marketing industry is among those who pay these high rates. We believe in fairness and a level playing field. We believe in the free enterprise system. Our industry is probably one of the most competitive in the world, and one of the most productive. We believe in the allocation of assets by the market place. We think all industries should compete in the market place on an equal basis and that decisions should be based on sound business and economic reasons and not on tax reasons. We believe that would be in the greater public interest and would promote a more viable and efficient economy for all. We believe that on the individual level, the perception of unfairness with the present system is rapidly growing and has become an extremely serious detriment to the self-assessment system. With few exceptions, there is simply no justification for individuals with approximately equal economic incomes to pay drastically different amounts of tax.

Now, Mr. Chairman, let me turn to some specific issues.

First, we strongly support the proposed corporate and individual rate reductions. FMI has made the point for many years that an absolutely vital element of tax reform should be significant reduction in effective tax rates. The food industry has paid, and is paying, extremely high effective rates. The proposed reduction in the corporate rate to 33% and the proposed retention and improvement of the graduated rate for small business are, therefore, of absolute prime importance to our industry. Likewise, the reduction of rates for individual taxpayers is a prime objective. High rates spawn pressure for exceptions to favor one group or another, or one industry over others. This has contributed to the existing present-law situation of wide variations in the effective tax rates as between industries, and as between individuals, although they may have approximately the same economic income. Thus, in this context, any diminution of the proposed reduction to 33% in the corporate tax rate would be of great concern to FMI. In particular, changes in other components of the Treasury proposal relating to business which would lessen this rate reduction would be viewed as reason for the food distribution industry to re-evaluate seriously its support for a reform package.

Second, FMI strongly supports relief from the double taxation of corporate dividends paid to shareholders. In this context, we viewed with great approval the provisions in Treasury I for a deduction of one-half of dividends paid to shareholders, and we were disappointed to see that the President's proposal reduced the 50% to 10%. As you develop a Committee bill, if you make major changes in the business provision of the President's proposal, we strongly urge that you restore the deduction for 50% of dividends paid. The food industry has a history of paying a significant portion of earnings to shareholders. Double taxation of these dividends puts companies which pay dividends at a disadvantage relative to other companies that don't have such a dividend policy and, of course, puts equity financing at a disadvantage compared to debt financing. When corporate profits are taxed at the corporate level under different effective rates, depending on the tax situation of the particular corporation, and then taxed at the individual level at different rates, depending on the individual situation, the widely different total rate on this source of income is evident. FMI views relief from this double taxation as a critical component and an extremely important part of any package. Such relief should lead to increased business investment and should generally strengthen corporate finance and certainly promote fairness and equity.

Third, a component of the President's proposal of particular importance to all retailing, and especially small business, is the indexing of inventories. FMI was disappointed at Secretary Baker's shift in position on the inventory issue when he advised the Ways & Means Committee that dropping inventory relief was one of "three possible modifications" to make the President's proposal "revenue neutral." We feel this was a serious mistake and urge this Committee to include this item in your bill.

The use of an indexed FIFO method and the repeal of the LIFO conformity rule would be very significant improvements. The food marketing industry is "inventory intensive" as well as labor intensive. The existing unindexed FIFO method imposes a penalty in times of inflation. Because of the LIFO conformity rule, and because of LIFO complexities, many small grocery firms still use the FIFO method - at least two-thirds of the total, according to Treasury -- and have thus been penalized during the recent inflationary economy. Thus, the proposals to index FIFO and repeal the LIFO conformity rule are important changes we support.

However, we would point out that the implementing details of the President's proposal are not included in the printed document. It has been our industry experience that this is an exceedingly complex subject in terms of the mechanics. FMI had an industry LIFO committee which spent nearly five years working out many issues with the Treasury Department technicians. Upon inquiry as to the details of the President's proposal, we were advised by Treasury that the details would be left to regulations to be resolved. We urge strongly that this not be left completely to the regulatory process but instead general guidelines be set out specifically in the statute. A proposal in this regard, which we support, has been developed and is attached to this statement.

In conclusion, members of our industry recognize their responsibility to pay their fair share to taxes as members of the business community. FMI supports the President's tax proposal as an overall and complete tax plan. We believe that to be effective, a tax reform bill must be viewed in totality and not in separate unrelated sections. Some provisions of the proposal will have the effect of increasing the taxes of some of our members in the short run. However, they have expressed their willingness to bear this cost in order to get a system that will be more equitable for the longer term.

Mr. Chairman, we again commend you and the members of the Committee and we urge this Committee to move ahead with its work. If you develop a Committee bill, we believe it should be judged as a totality. The test would be "is it true reform, or is it merely further patchwork which retains most of the existing inequities?" We stand ready to support and work for true tax reform.

GROOM AND NORDBERG
CHARTERED

Statement to

The House Committee on Ways and Means

and

The Senate Committee on Finance

July 25, 1985

RE: The President's Tax Proposals -- Source of Dividends Paid by Domestic 80-20 Companies to Foreign Shareholders

I. Introduction

Under the President's Tax Proposals, a dividend paid by a domestic corporation that earns more than 80 percent of its income from sources outside of the United States would be treated as a dividend from sources within the United States. One consequence of this rule is that foreign shareholders would be subject to U.S. withholding tax on such dividends for the first time. It is inappropriate, however, to impose U.S. tax on dividends paid to foreign shareholders out of income that has been earned outside the United States and in other countries. Accordingly, the President's Tax Proposals should be modified to eliminate this inappropriate consequence of a rule primarily designed to deal with problems perceived to arise when dividends are paid to U.S. shareholders.[*]

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[*] The issues raised by this statement apply to interest as well as to dividends. For ease of exposition, however, this statement generally refers only to "dividends" in lieu of "dividends and interest."

II. The President's Tax Proposals Would Change The Treatment Of Dividends Paid By Domestic Corporations With 80 Percent Foreign Income.

Under current law, a dividend paid by a domestic corporation is considered foreign source income if 80 percent or more of the corporation's gross income is foreign source. This source rule for dividends paid by so-called 80-20 companies has two major consequences. First, if the foreign source dividend is received by a U.S. shareholder, the dividend increases the shareholder's foreign tax credit limitation, the numerator of which is the shareholder's foreign source income. Second, if the foreign source dividend is received by a foreign shareholder, the dividend is not subject to U.S. withholding tax, which applies only to U.S. source income.

Under the President's Tax Proposals, dividends from 80-20 companies would be considered U.S. source income. As a result, 80-20 dividends would not increase the foreign tax credit limitation of U.S. shareholders and could be subject to U.S. withholding tax if paid to foreign shareholders. The reasons for this proposed change are explained as follows (page 400):

> Because foreign countries normally do not tax [dividends from 80-20 companies], the treatment of the 80-20 company dividend as foreign source may have the effect of making what would otherwise be excess foreign tax credits usable. This occurs despite the fact that a full foreign tax credit is available with respect to the foreign tax on the 80-20 corporation's operating income. Very often the result will be the total exemp-

tion of the 80-20 dividend from shareholder level tax either in the United States or in the country where the earnings were derived. Moreover, foreign taxpayers may be able to use an 80-20 holding company to convert distributions by U.S. operating subsidiaries into foreign source income and thereby avoid U.S. withholding tax on those distributions.

III. Any Changes In The 80-20 Rules Should Not Apply To Dividends Paid To Foreign Shareholders.

By treating 80-20 dividends paid to foreign shareholders as U.S. source income, the President's Tax Proposals would subject these dividends to U.S. withholding tax for the first time. The question is whether such taxation is appropriate.

We believe it clearly is not appropriate to impose U.S. withholding tax on dividends paid to foreign shareholders out of foreign source income that a domestic corporation has earned in other countries. For instance, a domestic holding company may derive all of its income from business operations conducted by its subsidiaries in foreign countries. This foreign source income would, accordingly, be subject to tax in those countries. Under these circumstances, there simply is no proper basis for the United States to impose withholding tax on dividends paid by the domestic holding company to its foreign shareholders out of the foreign source income derived by its subsidiaries.

The imposition of withholding tax on 80-20 dividends is also contrary to the following four principles set forth by the President's Tax Proposals (page 399) in formulating appropriate source of income rules.

1. The source of income "should reflect the location of the economic activity generating the income and the source of legal protections facilitating the earning of that income. Income derived from the use of property or capital ordinarily should be sourced where the property or capital is used." In the case of an 80-20 company, the economic activities, legal protections, property and capital are mostly located in the foreign country from which the company derives its income, so that 80-20 dividends paid to foreign shareholders should be foreign source income that is not subject to withholding tax.

2. "[I]nternational norms should [generally] be followed to the extent such norms exist." Many countries determine source of dividends and consequent withholding tax liability on the basis of where the corporation is managed and controlled rather than where it is incorporated. For instance, a corporation organized in the United Kingdom, but earning all its income from a non-U.K. business, would likely be managed and controlled in that other country so that its dividends would not be subject to U.K. withholding tax. Thus, the current treatment of 80-20 dividends paid to foreign shareholders is consistent with the rules applied by a number of other countries.

3. The source "rules should not allow erosion of the legitimate U.S. tax base...." The current rules exempting from withholding tax 80-20 dividends paid to foreign shareholders out of foreign source income do not erode the legitimate U.S. tax base. As discussed further below, any concerns relating to the taxation of 80-20 dividends paid to U.S. shareholders are not relevant to foreign shareholders.

4. "[T]he rules should operate clearly and not require difficult, factual determinations on a transaction by transaction basis." The current 80-20 dividend rules do operate clearly without difficult factual determinations.

Thus, under the principles set forth by the President's Tax Proposals, the current rules for 80-20 dividends paid to foreign shareholders are appropriate and the proposed change to these rules is inappropriate. Moreover, Congress has recently applied similar principles to dividends paid by foreign corporations. Under section 904(g) (enacted in 1984), dividends paid by a foreign corporation out of U.S. source income retain the U.S. source of the underlying income. The principle of this rule should apply equally to converse situations. That is, the current 80-20 rule should be continued so that dividends paid to foreign shareholders out of foreign source income retain that source so that the dividends are not subject to U.S. withholding tax.

The President's Tax Proposals express concern (quoted above) that the current 80-20 rule may increase a U.S. shareholder's foreign tax credit limitation and thereby "mak[e] what would otherwise be excess foreign tax credits usable." This concern, however -- whatever its merits with regard to U.S. shareholders -- is not at all relevant to 80-20 dividends paid to foreign shareholders not qualifying for the U.S. foreign tax credit. Any perceived problem relating to the foreign tax credit limitation of U.S. shareholders can be solved without inappropriately imposing withholding tax on 80-20 dividends paid to foreign shareholders.

The President's Tax Proposals also express concern that foreign shareholders may be able to use 80-20 holding companies to avoid withholding tax on dividends paid out of U.S. source income. Since, by definition, at least 80 percent of the gross income of an 80-20 company is from foreign sources, use of such a company to avoid U.S. withholding tax on U.S. source income does not appear to be a major problem. Accordingly, it is not necessary to change the 80-20 sourcing rule for dividends paid to foreign shareholders. However, if the problem of avoiding U.S. withholding tax on the small portion of 80-20 dividends paid out of U.S. source income is nonetheless viewed as warranting a change in law, dividends from an 80-20 company could be treated as U.S. source income to the extent the dividends exceed the company's foreign source income.

IV. Summary And Conclusion

The changes in the rules for 80-20 companies would impose U.S. withholding tax on dividends and interest paid to foreign shareholders out of foreign source income. It is an inappropriate exercise of taxing jurisdiction, however, for the United States to tax foreign shareholders on income originally derived in foreign countries. Any perceived problems that arise in connection with 80-20 dividends and interest paid to U.S. shareholders can be resolved without imposing inappropriate taxation on foreign shareholders. Accordingly, the President's Tax Proposals should be modified so that 80-20 dividends and interest continue to be treated as foreign source income for purposes of the U.S. withholding taxes imposed on foreign shareholders by sections 871(a) and 881(a). This modification would include situations in which dividends and interest are paid through successive tiers of 80-20 companies in the same affiliated group before ultimate distribution to foreign shareholders.

TREASURY II TAX PROPOSAL COST RECOVERY SYSTEM

by

Minnesota Society of Certified Public Accountants
Committee on Federal and State Taxation

Authors: S. Krishnan, CPA
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Dan Danielson, CPA

July 1985

The Capital Cost Recovery System (CCRS) proposed by President Reagan to Congress in May, 1985 is an inflation-based recovery system. It allows recovery allowance for depreciable assets based on increases related to an inflation factor.

The enactment of this proposal would introduce objectionable complexities into the Internal Revenue Code. The implementation of this proposal would be costly and confusing for several reasons.

First, the utilization of CCRS would create permanent disparities in the basis of fixed assets for accounting and tax purposes. These differences would generally be permanent, and would only increase over time.

Second, the basis computation is required to be made separately for each asset. Taxpayers with large investments in fixed assets would be faced with an awsome annual requirement in keeping records updated and accurate.

Third, there is some question as to the index to be used. Will one index rate be applied to all assets regardless of type or use? If so, the inflation factor would not represent fairly the relative change in economic value of the property in question as related to different industries or different usage. Would the index rate be a regional one? If so, what happens when property is moved from one region to another? Would taxpayers be tempted to position property during or at the end of their fiscal year to maximize inflation index rather than productivity? Would the index rate be by classification in the CCRS table? While this addresses to some degree the problem of relative change in economic value, it raises the further problem of misclassification. If a property is inadvertently included in the improper class and so adjusted for part of its recovery period, how does one correct the error? Would taxpayers who filed returns in good faith be faced with the task of amending prior year's returns for such an oversight?

Fourth, the enactment of CCRS would bring another capital recovery system into the tax system. At the present time, we are dealing with:

- Pre-ACRS rules;
- ACRS rules as originally enacted;
- ACRS rules as modified by the Reform Act of 1984.

Even if the ACRS system would disappear within the next 17 years, and if the pre-ACRS rules also disappear, the proposal contemplates a system which has not only the basic CCRS formulations, but separate ways for handling intangible assets, depletable assets, leasehold improvements and foreign assets.

During the transition, the taxpayer is confronted with a wide disparity of methods of capital recovery, each based on certain dates of acquisition and certain types of acquisition. The prospect is discouraging, to say the least.

Finally, the outlook is that CCRS will not itself remain the same for an extended period of time. The President's proposal envisions a permanent body of empirical study groups which will continue to refine the CCRS system, particularly with regard to lives and rates.

The President's recovery system, as proposed, is seriously flawed. It is unfair to the small entrepreneur, since the complexity inherent in the system seriously burdens the type of business that usually lacks the revenue or the resources to deal with it effectively. It raises questions of compliance which are difficult to deal with, many of which may not be settled for years. It is unnecessarily complex, leading away from simplification rather than into it.

TREASURY II TAX PROPOSAL DENIAL OF RATE REDUCTION BENEFIT ATTRIBUTABLE TO EXCESS DEPRECIATION FOR CERTAIN TAXPAYERS

by

Minnesota Society of Certified Public Accountants
Committee on Federal and State Taxation

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July 1985

The President's proposal for Fairness, Growth and Simplicity contains a proposal to levy a tax on taxpayers who have benefited significantly from accelerated depreciation between 1-1-80 and 6-30-86. Under the proposal, 40% of the excess of accelerated depreciation over straight line depreciation in excess of $300,000 is included in income over 3 years beginning in 1986.

The proposal is essentially a revenue raising bill - it is not tax reform. Because of this, it should not be included in a reform proposal.

The proposal is not based on fairness. It is based only on depreciation taken in the 6 year period. By that assumption, it appears that the only section of the tax code that has provided a benefit that is substantially unfair is the depreciation section. It ignores other so-called windfalls that have been available to taxpayers. The reduction in individual rates from 70% to 50%, or the corporate rates from 48% to 46%, did not produce any corresponding legislation to recapture some of the "windfall". This is unprecedented in our history of taxation.

It is unfair because it heavily penalizes those who invested in the recent expansion in the American economy. Those who responded to the incentives offered are now being told that they can only share in the benefits of those incentives to a limited extent. It can be considered a retroactive modification, if not repeal, of ACRS.

It is unfair because the computation is based upon arbitrary methods. The amount of "benefit" by the taxpayer is based on assumptions, the time period for inclusion is based on assumptions - all of which are arbitrary. In the interest of simplicity, the proposal sacrifices fairness.

While the concept itself is not complex, the method of computing the tax is. It is based upon the excess of depreciation as calculated for the tax return over the straight line depreciation that would have been computed for the same assets using the lives designated for earnings and profits. These lives are significantly longer than the depreciable lives allowed for tax purposes - usually 150% to 200%. As a result, the "benefit" that is computed is far greater than the benefit received from the depreciation originally taken. The proposal makes the point that this computation is simple to accomplish, since taxpayers are making this computation annually. Practically speaking, no one makes computations of earnings and profits until it is necessary. As a result, most businesses do not make annual, separate computations.

It is unfair because taxpayers will be required to show additional income, resulting in additional tax, without any cash flow with which to pay the tax. It is apparent that if all the cash that may be available due to rate cuts must be paid back to the Treasury in the form of additional taxes, there is not money left for growth and investment.

In summary, it is not a tax reform proposal, it is a revenue raising proposal. It seeks to assess a tax against certain taxpayers through a system of complex computations. It is a way of appearing to reduce the tax rate without actually reducing it. There are better and simpler tools available to raise revenue should a system demand it.

PHCC

National Association of Plumbing-Heating-Cooling Contractors
Pride In Our Past—Faith In Our Future

Statement
# of the
National Association of Plumbing-Heating-Cooling Contractors

On the President's Tax Reform Proposal
Before the
Finance Committee
United States Senate
Washington, DC

October 4, 1985

180 S. Washington Street. P.O. Box 6808, Falls Church, VA 22046 • 703/237-8100

NAPHCC supports the tax reform initiative of the President and we have urged our members to absorb their share of this reform. However, we cannot support any proposal which will negatively affect the growth of the construction industry.

NAPHCC has over 6500 members throughout the country and is organized through about 300 state and local chapters. Altogether, this industry employs 400,000 people and has 21 billion dollars of annual revenue. Our association is the largest in the plumbing-heating-cooling industry and the oldest in the construction industry.

We agree that the tax code should be simplified, tax rates reduced, and tax provisions eliminated which do not contribute to the efficiency of the economy. Simplification will enhance our free enterprise system. Investment decisions will be made on their own merits and not on the basis of what will provide the most favorable tax consequences.

The President's proposal is a balanced effort that will make the tax structure more equitable. In the long run, it will stimulate the economy, encourage investment and create growth in taxable income that can assist in balancing this nation's deficit woes.

The construction industry is a major component of the nation's economy. therefore, a healthy construction economy is critical to a healthy national economy.

While simplifying the tax code to promote greater incentive to the economy, the Congress must be careful not to produce disincentives which damage economic health. Proposals which adversely affect this nation's construction economy may, in turn be injurious to the national economy. Likewise, a tax reform package that stimulates construction will have a beneficial impact on the national economy.

NAPHCC is a member of the National Construction Industry Council (NCIC). We are also a participant in the study commissioned by NCIC to analyze the impact of the tax reform proposals on the total construction economy and on segments of it. We expect that the results of this study by Data Resources, Inc., will quantify the effects of proposals in the tax package. Results of this research will be provided to the committee when it becomes available.

However, we can provide general observations on the effects on construction of several major components of the package.

In urging the rejection of some of those proposals, we do so to avoid greater revenue losses to the treasury. If tax proposals produce a negative impact on the construction economy, those will magnify as their impact reaches the total economy.

In a recent economic study, Data Resources, Inc., identified a GNP multiplier effect of 2.35 for every dollar spent on construction. As the construction economy expands, there is 2.35 times as much economic activity in GNP. However, if construction contracts, there is 2.35 times less economic activity. Thus, if GNP contracts, the taxable revenue base also contracts and larger federal deficits are sure to result.

Capital Cost Recovery System

We were supporters of the accelerated cost recovery system (ACRS) enacted under the Economic Recovery Tax Act of 1981. The system provided incentives for investment in new equipment and buildings to promote modernization through the rapid depreciation schedules.

While we still believe there was merit in that approach, the President's proposal for the new capital cost recovery system (CCRS) also has merit. Although depreciation of vehicles and equipment would take longer, CCRS permit an adjustment for inflation to the value of property and allows contractors to recoup the replacement value.

We expect that CCRS would decrease the amount of depreciation that would be taken in any taxable year and thus increase taxable income. However, the increase in taxable income would be at least partially offset by the lower corporate tax rates in the President's proposal.

The CCRS proposal also would extend depreciation of buildings to 28 years. Under ACRS in existing law, buildings are depreciated over 18 years and certain low income housing over 15 years.

Certainly a 28 year depreciation schedule is preferable to the 63 years which was proposed by the Treasury Department in the first tax reform proposal. However, it is still to long a period and will produce a significant dampening of construction activity. Lengthening the depreciation period to 28 years will decrease construction.

With construction a major component of GNP, the longer depreciation period may reduce construction investment and economic growth, thus producing a revenue loss. Not just construction, but everyone is hurt.

Continuation of 18 year and 15 year depreciation, as provided in ACRS, will retain investment in buildings, continue construction activity, and maintain federal revenue.

Investment Tax Credits

Investment tax credits (ITC) provide a valuable incentive to purchase property for use in a trade or business. They provide a mechanism for companies to lower their taxes and to use the revenue to reinvest in their business. By stimulating investment in this way, tax policy promotes production, and the modernization of equipment and facilities. These provide ongoing economic stimulus.

However, we also recognize that these credits have produced tax havens for some companies without producing real economic advantage to the nation. ITC's generally are more beneficial to the well financed, successful company which has revenue it wishes to shelter from taxation.

The struggling company may not have enough taxable revenue to make effective use of investment tax credits. Such a company does not receive the same incentive to invest in property which might improve the productivity of its business.

Elimination of ITC's under the President's plan helps to lower corporate tax rates. Unfortunately, the struggling company won't benefit from a lower tax rate much either if taxable income is neglible.

Is construction activity among the more successful compaines stimulated more by use of the investment tax credits or by the lower tax rates? Without the benefit of results from the NCIC study, we are inclined to support lower corporate rates in the interest of promoting tax simplification.

Completed Contract Method of Accounting

The President's proposal would revise accounting rules to eliminate long established accounting procedures permitted in the construction industry thru the completed contract method of accounting (CCM). Elimination of CCM is short-sighted, and fails to recognize unique characteristerics of the construction industry. It was the unique nature of construction which resulted in recognition of CCM back in 1918 and has continued to the present.

While seeking to simplify and standardize accounting rules, the President's proposal acknowledges that some industries may still require separate consideration. Fox example, the proposal notes, "Special rules would recognize the special circumstances of certain industries" (Page 207).

The unique characteristics of construction should be recognized. Among these are:

- Differing sites for each project which are not controlled by the contractor but determined by owner needs.
- Varying soil conditions from site to job site and from project to project.
- Changing climate conditions outdoors, with each day's production influenced by weather conditions.
- Firm prices for the duration of a contract which require the contractor to bind himself to a price before actual costs are known and eventual working conditions established.
- Owner retention policies, wherein an owner retains part of his payments until contract completion and final acceptance by the owner. This retained amount is usually more than the realized profit.

- Changes, modification or claims during the course of the contract which require the construction contractor to spend large sums in advance of his contractual right to fully collect payment revenues from the owner.
- Intense competition within the construction industry which forces profit margins to be exceedingly small in relation to the total gross contract amount.

Abuses of CCM are not being found in the construction industry, but rather among large companies who manufacture large products under multi-year contracts. Congress recognized this in 1982 when it exempted construction contracts lasting less than 36 months and contractors with less than $25 million in gross receipts. This preserved use of CCM for construction while permitting changes in cost allocation which had been proposed by the Treasury Department.

Loss of the completed contract method for construction contractors would likely result in bankruptcy of many. They would be required to pay taxes on revenue from projects before all expenses associated with the project have been identified.

Congress should reassert that continued use of completed contract principles would continue to be applicable to the construction industry.

Income Averaging

Although income averaging is not permitted for corporate tax filers, current tax law permits it on individual returns. With more than a fifth of our members operating their businesses as sole proprietorships or partnerships, income averaging has given them greater flexibility in dealing with the cyclical nature of the construction business.

Because of the cyclical nature of construction, contractors may experience several lean years before the economy rebounds. During those lean years, business expenses continue and taxable income is at a low. When the business begins to fluorish, the contractor has a larger taxable income and a higher tax bracket. With income averaging, he is better able to preserve funds for reinvestment in the business. Income averaging provisions provide a good transition for taxpayers who suddenly find increased income and helps contractors even out tax payments.

The same principles apply for new contractors going into business. Starting out as very small unincorporated businesses, their expenses may be great. However, their income may not be. Income averaging helps these new small businesses to develop.

The President's Tax Proposals note that young people completing their studies have been able to slip through the loopholes to make use of income averaging. Those provisions could be tightened up rather than eliminating use of income averaging by those who are subject to cyclical business conditions.

The President's proposal also suggests that there is less need for income averaging with the changes in the rate structure. However, the lowered rate structure is part of a package that also includes the reduction or elimination of offsets to income such as depreciation and tax credits. Combined these adversely affect the small business sole proprietorship who suddenly has a good year, but is no longer entitled to other tax prvosions that would enable him to even out his tax liability.

It would be more equitable to retain the income averaging provisions. These provide more balanced taxation for the unincorporated small businessman who has recently entered the business or faces the constantly changing nature of a cyclical economy.

Industrial Development Bonds

Industrial development bonds (IDB) are used by states and cities to develop the economic base in the community. Both the new business and the construction which permits it to locate there provide economic stimulus to the community. Thus, the IDB has provided benefit to the community, the new business establishment and the construction industry in the community. IDB's appear to be important tools to communities to developing their infrastructure.

Is it inequitable that higher income taxpayers shield their income through purchase of the bonds? Would other financing mechanisms develop? Certainly with the reduction in tax rates, IRB's will be less desireable, and new ventures may need to fend for themselves. Some may not even be developed. The NCIC study should provide data on the importance of such bonds to construction.

Interest Deduction Limitations

Limitations on the deduction of interest will slow the flow of funds to construction. Where construction funding comes from limited partnerships, investors no longer would be able to get a significant tax advantage for interest deduction from their investment. This would have a dampening effect on the construction economy.

It is the impression of our members that investment in second homes would not be significantly affected by the limit on interest deductions. Many tax payers who use a second home extensively would continue to. Those who use their second homes for a brief vacation would also continue to do so. This latter group of taxpayers can continue to rent the residence out during the remainder of the year as a business rental property and maintain their deduction for interest on indebtedness.

Thus, while there might be some minimal impact on construction of second homes, the bigger effect of the limitation on interest deductions would be the reduction in investment which is channeled through limited partnerships. Again, we hope that the NCIC study will provide data to shed light on the impact of the proposal on construction.

Rapid Amortization for Low Income Housing

Current tax law permits 5 year amortization for rehabilitation of low income rental housing. This rapid amortization has promoted the development and restoration of housing for low income Americans. Because the costs are amortized rapidly, the rental cost can be held down.

Although the President's program suggests that low income housing could be provided by targeted spending programs, the pressure to reduce federal spending and balance the budget makes that option less likely. Contrary to the analysis in the President's proposal, we believe this rapid amortization has promoted rehabilitation and not drawn funds away from new construction. We are hopeful that the NCIC study will provide information on this proposal's impact on construction.

Taxation of Employer Provided Health Insurance

Fringe benefits, such as health insurance, have become an established employment related mechanism to attract and retain employees. With the almost universal offering of health insurance programs by employers, it has also become a very constructive and positive way to provide for the health needs of the people of this country, using the private sector rather than publicly funded programs. Tax policy should encourage, not discourage continued use of the private sector approach to providing health care coverage.

While we are concerned about crossing the threshold to greater taxation of fringe benefits, it may be acceptable to tax employer provided health care premiums if structured properly to provide equity and to promote a slow down of rising medical costs. The President's program could do this more effectively if it incorporated the provisions of the first Treasury proposal rather than the President's Proposal. Including employer contributions to a health plan as part of a gross income up to a certain floor leaves the health care programs open to continued escalation of health care costs and therefore the premiums which employers pay.

The Treasury's first proposal called for allowing basic health coverage to be tax free and for premiums above the floor to be included as income for employees. This method would be far more effective as a means to tax excessive fringe benefits and promote employees' sensitivity to holding down rising medical costs.

If health care premiums are to be taxed, NAPHCC urges the Congress to adopt the Treasury's first approach. This will provide a simple, more equitable approach across the economy.

Rehabilitation Tax Credits

Rehabilitation tax credits provide a tax incentive for the restoration of older and historic buildings. These tax credits serve to preserve historic structures that might otherwise continue to fall into disrepair or be demolished. Use of these credits have provided construction activity that is healthy for the construction industry and the economy.

In a time when there is increasing concern for the deteriorating infrastructure, these provide a mechanism to restore these buildings to active use. Until the NCIC study is complete, we do not have the date to judge whether there might be other development which is equally advantageous.

Support for Tax Increases

As indicated in our opening comments, we are not seeking to protect tax benefits for our industry, but rather supporting a sound construction economy. We are willing to absorb our share of taxes which fall to us under the tax reform proposal. That's why we are willing to accept proposals which may increase taxes. Among these are:

- Loss of deduction for state and local taxes
- Limits on deductibility of entertainment and business meal expenses
- Repeal of the credit for political contributions
- Repeal of energy tax credits

These do not have the significant adverse effects on the construction economy which the other proposals may have.

Furthermore, we support the lowering of corporate tax rates as part of the overall tax program even though the net effect may be to increase the taxable income of our member contractors. With the loss of credits, such as the investment tax credit, and the reduction in depreciation under CCRS, there will be less offsets to a contractor's revenue that may result in a net tax increase despite the reduction in corporate rates.

Conclusion

In conclusion, Mr. Chairman, NAPHCC does support the tax reform initiative of the President. We are willing to accept our share of the tax burden that results from this reform even though it may be an increase in tax because of the importance of simplifying the tax code and providing more equitable provisions. However, we cannot support proposals which may adversely affect the growth of the construction industry.

We are proud of the contributions which the construction industry and particularly our plumbing, heating, cooling segment of construction have made to our country and our economy. As a key component of the economy, we believe that the construction economy must remain strong and viable to continue to play its rightful role.

We plan to continue to work with other segments of construction to accomplish that and would not want the tax laws to thwart those efforts.

As we obtain more detailed data on the impact of the tax reform proposals on construction through the economic research being conducted by the National Construction Industry Council, we will make that available to the Committee and the Congress.

Thank you for giving us this opportunity to express NAPHCC views on tax reform.

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STATEMENT

OF THE

NATIONAL AUTOMOBILE DEALERS ASSOCIATION

ON THE

PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY

BEFORE

THE SENATE FINANCE COMMITTEE

OCTOBER 2, 1985

October 2, 1985

Mr. Chairman and members of the Committee:

My name is William J. Symes and I am President of The National Automobile Dealers Association ("NADA"). I am also a franchised new car dealer from Pasadena, California. On behalf of NADA's 19,000 new car and truck dealers, I would like to express our appreciation for the opportunity to testify before this Committee on tax reform, and more specifically on the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity (the "Plan").

NADA is a national trade association whose members are independent franchised automobile dealers located in all 50 states and the District of Columbia. NADA members engage in the retail sale of both new and used automobiles and trucks, both domestically produced and imported. Additionally, virtually every NADA member is engaged in the automotive service and parts business. We believe that the interests of our membership are consistent with those of small independent businessmen operating in every sector of the economy.

In an attempt to determine the impact of enactment of the Plan on new car sales and on our members as taxpayers, we have carefully analyzed the proposal and its effect on the tax liability of our members. To this end we have reviewed tax returns of a representative sample of our dealers, both large and small, and have attempted to compare their tax liability under present law with their projected tax liability under the Plan. Based on this analysis, NADA strongly supports and endorses the Plan without any substantial modification.

Tax Reform and the Automotive Market

A number of provisions of the Internal Revenue Code discourage the purchase of an automobile. First, possible imposition of tax at rates as high as 50 percent reduces disposable income and leads some individuals to divert funds otherwise available for the purchase of consumer goods to the purchase of tax shelters and other tax-favored investments. In addition, the so-called luxury car provisions do not treat automobiles purchased for use in a trade or business in the same fashion as other business assets, but instead single out automobiles and subject them to less favorable depreciation and investment tax credit rules. We believe this leads some businessmen to defer purchases of the cars that they use in a trade or business and accelerate purchases of other, tax-favored, business assets.

The Plan would amend each of the provisions of the current Internal Revenue Code that has a significant effect on sales.

First, individual tax rates would be reduced, with the maximum individual income tax rate set at 35 percent. Second, the investment tax credit would be repealed for all property, putting business cars on a more equal footing with other business assets. Third, a new depreciation system would be provided, the Capital Cost Recovery System ("CCRS"), under which recovery periods would be lengthened and assets would be indexed each year for inflation. According to the Administration's description of its proposal, "CCRS is designed to provide neutral investment incentives" by minimizing "the variance in effective tax rates among different assets and industries". Consistent with its goal of a more neutral depreciation system, the Plan appears to treat automobiles purchased for use in a trade or business in the same fashion as other assets of the same class.

When viewed as a whole the proposed changes would have a positive effect on the automotive market. First, the reduction in individual tax rates will create more disposable income, and is therefore likely to result in increased consumer spending on all durable goods, including automobiles. Second, if the depreciation system proposed by the President is, in fact, neutral with respect to investment incentives, and the disincentive to the purchase of a business automobile contained in present law is eliminated, purchases of business cars will increase.

We note with some concern that new rules would limit the deductibility of consumer interest. Under the Plan, the deduction for interest not incurred in connection with a trade or business, other than interest on debt secured by the taxpayer's principal residence, could not exceed an amount equal to $5,000 increased by the amount of the taxpayer's net investment income. Since a substantial number of consumers finance their purchase of automobiles, a limitation on the deductibility of interest may, under some circumstances, discourage purchases. Nonetheless, we believe that so long as the cap is not reduced below $5,000 of interest per year, there will be no substantial reduction in automobile sales. A $5,000 limitation would rapidly become inadequate, however, during periods of high inflation or rising interest rates. Consequently, we strongly urge the Committee to consider indexing this $5,000 limit.

Tax Reform and the Automobile Dealer

We believe that the current Internal Revenue Code generally is inhospitable to automobile dealers as taxpayers. Dealers are subject to the excessively high rates of tax imposed under current law[1/] without being able to take advantage of the many

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[1/] Most NADA members have incorporated their automobile dealerships, and accordingly are subject to the corporate income tax. Some of these have elected S corporation sta-

(Continued next page)

provisions of the law that permit more favored taxpayers to shelter income and to reduce their effective tax rates. For example, few dealers take substantial amounts of depreciation or investment tax credit. Further, many are unable to take advantage of the highly complex last-in-first-out ("LIFO") inventory accounting rules that permit more sophisticated taxpayers to reduce income from sales during periods of inflation.2/ Thus, we believe that under current law, many dealers pay more than their fair share.

An Internal Revenue Code revised by the Plan would be more equitable to automobile dealers. Under the Plan, corporate, as

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(Continued)

tus, so that the corporation does not pay any income tax, but the owners of the business are taxed directly on the corporate income. Accordingly, both the corporate and the individual income tax rates are relevant to the treatment of the automobile dealer as a taxpayer. Under present law, corporate taxable income in excess of $100,000 is taxed at a maximum rate of 46 percent. Corporate income under $100,000 is taxed at graduated rates ranging from 15 percent to 40 percent.

2/ Income from the sale of inventory is calculated by matching the sales price of the goods with the cost of goods sold. Under current law, taxpayers who keep inventories account for the purchase and sale of inventory items under one of two methods. The first-in-first-out ("FIFO") method assumes that the first goods purchased or produced are the first goods sold. Thus, in periods of inflation, the FIFO method matches current inflated prices with costs incurred in an earlier year. The LIFO method, on the other hand, assumes that the last goods purchased or produced are the first goods sold, and matches current sales with the most recently acquired inventory.

well as individual, income tax rates would be reduced. A maximum rate of 33 percent would be imposed on corporate taxable income in excess of $75,000. Corporate income under $75,000 would be taxed at graduated rates; there would be three brackets of 15, 18 and 25 percent. Thus, the advantage enjoyed by those taxpayers who are able to use current law to reduce their effective rate of tax would be reduced.

In addition, a third method of inventory accounting, the indexed FIFO method, would be available to taxpayers under the Plan. The indexed FIFO method would permit taxpayers to adjust the basis of all of their inventory to account for inflation, so that taxable income would reflect only economic gain, and not inflation. In contrast to LIFO, however, indexed FIFO would be relatively simple and easy to employ. In other words, it would provide small businessmen, including many automobile dealers, with an opportunity to employ an inventory accounting system that takes inflation into account without having to bear the burdens associated with the use of LIFO.

The typical dealership is a small business that derives a substantial portion of its revenue from retail sales. As noted above, the typical dealer is not likely to benefit to any great extent from accelerated depreciation or any of the many other provisions of the Code that have favored taxpayers who derive their income from depreciable property. Further, the typical dealer may be too small to take advantage of the extremely complex LIFO inventory accounting rules. Thus, although the current Internal Revenue Code does favor certain business taxpayers, the typical automobile dealer is not among them. We believe, however, that by reducing individual and corporate tax rates, and by providing a simple straightforward accounting system for inventories that takes inflation into account, the Plan would eliminate much of the bias contained in the current Code.

* * *

The NADA salutes the Adminstration for its efforts. Although we recognize that certain provisions may not be favorable to our members, we believe that so long as (i) the corporate and individual income tax rates are reduced as proposed, (ii) the cap on consumer interest is not reduced below $5,000 and is indexed for inflation, and (iii) the new depreciation system does not treat automobiles used in a trade or business differently from other business assets, enactment of the Plan would benefit America's small business community, including its automobile dealers.

Committee on Finance Hearing

October 2, 1985

Effect of Tax Reform on American
Business Generally and its Impact
on the Foreign Tax Provisions

Solving the Trade Problem with Japan

Robert N. Noyce, Sep. 26, 1985

I've been asked to address you this evening on "Solving the Trade Problem with Japan". This is not an easy assignment . One of the primary motivations in the formation of the Semiconductor Trade Association back in 1977 was to address this very issue, and we have spent a disproportionate amount of time and treasure trying to figure out how to ward off a trade war with Japan while preserving our viability as America's premier innovative growth industry.

In the beginning we saw the problem in stark black and white. The Japanese were ticking off one industry after another on their priority list and through very aggressive export drives had driven American companies out of their own market, and often out of business. We heard complaints of illegal dumping, and in many cases, those complaints were substantiated by the ITC investigations which were carried out. We had seen the pattern in color television sets, and were about to see it in other electronic products.

Our first reaction was to say that if the Japanese would only play according to the rules of the game that we believed in, stop their subsidies and dumping, and open their markets, everything would be all right, and the American companies would maintain their historic roles of innovators and market leaders.

We saw the United States behaving according to the Post-World War II paradigm as leaders of the free world, maintaining global commitments as protector, benefactor, and mentor. The Marshall Plan in Europe, and the McArthur democratization of Japan were arguably the most effective and benevolent programs ever afforded by one nation to friends and foes alike after a major war. It never occurred to us that given our bountiful land, productive factories and educated and motivated work force, that our economic strength would weaken.

We provided leadership and the bulk of the financing for the post-war international institutions, such as the United Nations, the World Bank, the International Monetary Fund, and, through the General Agreement on Trade and Tariffs, led the drive for a more open and fair world trading system. That has been our objective in trade negotiation ever since.

So our basic beliefs were that in a fair and open trading system, competition would thrive and benefit all, by providing the motivation for each nation, and each individual to be his most productive, contributing the most he could to his society and the world society. Only "unfair practices" would prevent this Utopia from arriving, and we would take care of those cases by appropriate legislation.

Thus it is that we see all threats to the American position in foreign trade as being unfair, or as illegal according to American law. While there have clearly been cases of illegal action on the part of our trading partners which exacerbates our problem, I don't believe that such actions will explain the position in which American industries are today, although they have certainly been a factor, and must be eliminated to the best of our ability.

Until 1975, America enjoyed a generally positive merchandise trade balance. By five years later, in 1980, we had been running a merchandise trade defifit of about 20 billion dollars a year, but we were enjoying a trade surplus in services, so that overall our foreign sales and purchases were balanced. However, since that time, we have had an escalating trade deficit, including trade in services, which has now gotten to crisis proportions. American manufacturers are no longer competitive in world markets, and find that they are unable to maintain world market shares. Several million American manufacturing jobs have been eliminated as plants are being forced to relocate overseas to remain in business. What has happened in this period of time? With our basic beliefs in the consequences of free and fair trade, the answer could only be that we were doing a poor job, or that our trading partners were taking advantage of us unfairly, or even illegally. As a result there are now several hundred trade bills before Congress, most asking for protection for some specific industry, or for punishment of those trading partners whom we see as being unfair.

I don't believe that those unfair practices have escalated enough in the last five years to account for the mounting trade deficit, although the incidence of complaints under our trade laws has been increasing. So let's look deeper into the problem and look at other possible causes.

Chart 1

Beyond the trade deficit, the most striking statistic which appears is the increasing value of the dollar. Since 1980, the value of the dollar has been increasing steadily as compared to the currencies of our major trading partners, and is today 50% higher than it was then. In effect, American plants would have had to increase their efficiency 50% more than that of their foreign competitors in the last five years in order to maintain the same competitive position which they had in 1980. Without that rise in the dollar, the price of American goods (at least our value-added component) would be 33% lower to our trading partners, and their prices 50% higher for us, which certainly would increase exports and decrease imports. Even with our historical innovation, countering that disadvantage is a tall task. So tall a task, in fact,that in many cases we are not even trying. Every day decisions are being made to relocate plants, or to source materials offshore.

This week we have heard of efforts by the central banks to try to reduce the value of the dollar in order to avert protectionist legislation, and a possible trade war. That will be done by intervening in the foreign exchange markets using government funds. Such intervention can eliminate the component of the dollars rise due to speculation on foreign exchange markets, but it cannot counter the effects due to underlying causes without other policy changes? What is the underlying cause of the dollar's rise?

Our best way of looking at the dollar is to see it as any other commodity. If demand (borrowing) is larger than supply (lending), the price will rise. If, conversely, supply is larger than demand, the price will fall. So let us look at the supply and demand dollars in America.

Chart 2

The supply of dollars available for lending comes from savings, including those of individuals, businesses, and government (although the public sector seems to be a dissaver most of the time so we have to subtract the appropriate number). The demand arises from the net investments which are made in the private sector, since government investments are alreadyincluded in the government savings figures. The difference between the supply and demand is the excess (or deficit) savings of the nation. Looking at our performance as a nation, we see that the supply and demand was reasonably well balanced in the U.S. until 1980, at which time we started saving less than our investment needs.

But if we are not willing to save for our own investment needs, who will? Those funds come from other nations where there is a surplus of savings over their own needs. And since dollars are the exchange medium necessary for buying plants and equipment in the U. S., those nations have to acquire dollars. The source of dollars is also from the U.S. so we must have transferred those dollars overseas in order to be able to borrow them. That requires that the U. S. run a negative balance of trade, allowing dollars to accumulate overseas instead of being used to buy American goods. If the dollar had remained at its 1980 value relative to the currencies of our trading partners, that trade deficit would not have occurred. Thus we can usefully look at the value of the dollar as the intermediate variable which allows our equation to balance.

Chart 3

If we examine the historical trend of our surplus savings, our trade deficit, and the relative value of the dollar, the relationship becomes quite clear. If we have a savings surplus, we enjoy a low valuation of the dollar, and a trade surplus. Conversely, when we have a savings deficit, the dollar rises, and the trade balance goes negative. And, as you all know, in recent years the trade deficit has exploded to unprecedented values. That, in turn has caused a massive exodus of jobs from America to those nations willing to save, and lend our dollars back to us. In effect, we are trading our plants and homes for VCR's and Toyotas. We are transferring our wealth from our own populace to those willing to save by buying their goods, and then borrowing back the money we have spent.

Let me summarize this way: Our trade deficit (or surplus) will equal our savings deficit (or surplus), and the value of the dollar will reach the value necessary for that to happen!

Against that view of our trade problems, we can assess the validity of the various measures which have been proposed to solve the problems that we face.

Let us for example, take an overall tariff on all inported goods. Unless the relative increasein prices to the American consuming public convinced them not to make the purchase, but rather to save the money, the effect would be small. There would, of course, be a reduction in the federal deficit, due to the duties collected. As a matter of fact, since merchandise imports in 1984 amounted to about one-third of a trillion dollars, a 25% import duty would have eliminated the savings deficit, allowing a trade balance in spite of the retaliatory measures might have taken. Other than the reduction of the government deficit (increase of savings), the dollar would rise to nullify the effect of the duties, still balancing our equation.

We can also examine the probable effect of the proposed "Treasury II" tax revision. Since it is revenue neutral, this tax revision will not decrease government dissavings. Since it does shift 40 billion dollars of taxes from individuals, who are now saving about 4 1/2 % of their income to corporations which save about 60% of their after tax income, we would expect the net effect of the legislation to decrease total savings, requiring that the trade deficit increase.

The most effective way to balance trade would be to change the tax law in a way which would increase savings, either personal, corporate, or government. A tax increase would be a direct reduction of government dissavings, and would have a high yield in savings, particularly if imposed on the lowest saver, the individual. It would have higher yield if it encouraged saving, rather than consumption. The candidate here is of course a sales tax, or VAT, or the BTT, business transfer tax which has been proposed.

The most desirable way to take care of the problem is probably to cut government dissavings by cutting expenditures. The level of the government deficit alone is not the problem. Japan runs a higher deficit rate than does the U. S. but does not have our problem. But the Japanese people save an exceptionally high percentage of their income, allowing them to cover the government deficit, as well as their other investment needs with plenty to spare.

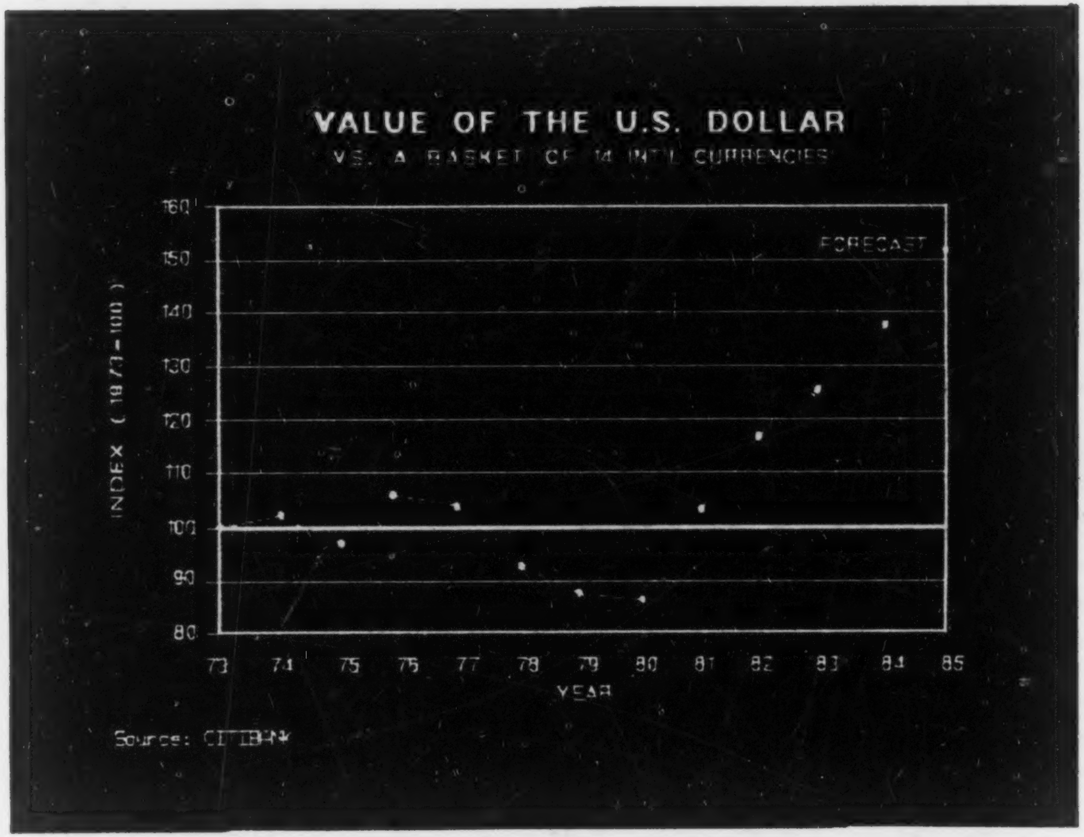
While the prescriptions for solving our basic trade problems are simple, accomplishing them is not. We are now living beyond our income, consuming more and saving less than is sustainable. The side effect of that consumption is the loss of American jobs, and the flight of American technology to those countries who are exporting to America, namely those nations which save more thanthey need for investment in their own countries. But to cure our problems, we will have to cut consumption to increase savings, in other words, to decrease our standard of living temporarily. That is difficult witho ut strong leadership willing to take on the task of identifying increased consumption with increased unemployment, and pointing out that a short term reduction in our consumption is necessary if we are to regain our traditional competitive position in world trade, and again enjoy an increasing standard of living.

Since this is such a difficult task, asking for sacrifice short term for long term benefit, it will require the concerted efforts of all of us to reach the required concensus for action. But if we do not reachthat concensus, our present actions could lead to a downward spiral. With increasing import penetration, without a commensurate increase of exports, more jobs will be lost. And although the number of service jobs has been growing, many of those will also move with the manufacturing jobs. The basic infrastructure supporting manufacturing jobs is best located in proximity to that activity. As those jobs are lost, tax revenues are lost, and "safety net" payments by the government increase, increasing our savings deficit. That, in turn will increase the trade deficit, leading to additional loss of jobs. Et cetera.

But rather than to be a prophet of doom at a time when we are already depressed, Let me suggest that the solution of the major part of our trade problem is indeed in the hands of the Americans, rather than in the hands of our trading partners. Having the road to survival in sight, we can expend the effort not only to survive this, the worst recession in the history of our industry, but we can be instrumental in revitalizing our entire nation.

We cannot relax our efforts to assure that our trading partners obey the rules of the game if we are to trade freely with them, to the benefit of all. But while doing so, we must correct the mistakes we have made in the past, avoiding easy solutions which are often counterproductive, and thinking through the consequences of the steps which we take.

As Pogo said, "We have met the enemy, and he is us".

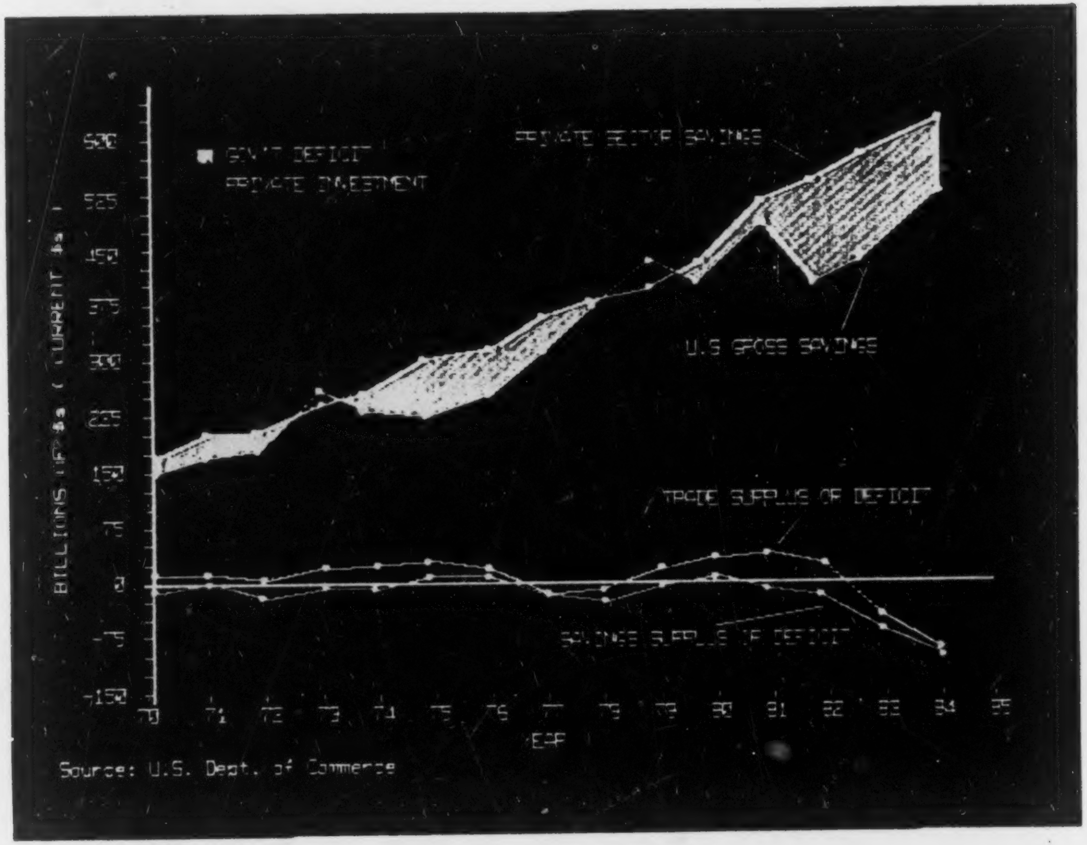


VALUE OF THE U.S. DOLLAR

VS. A BASKET OF 14 INT'L CURRENCIES

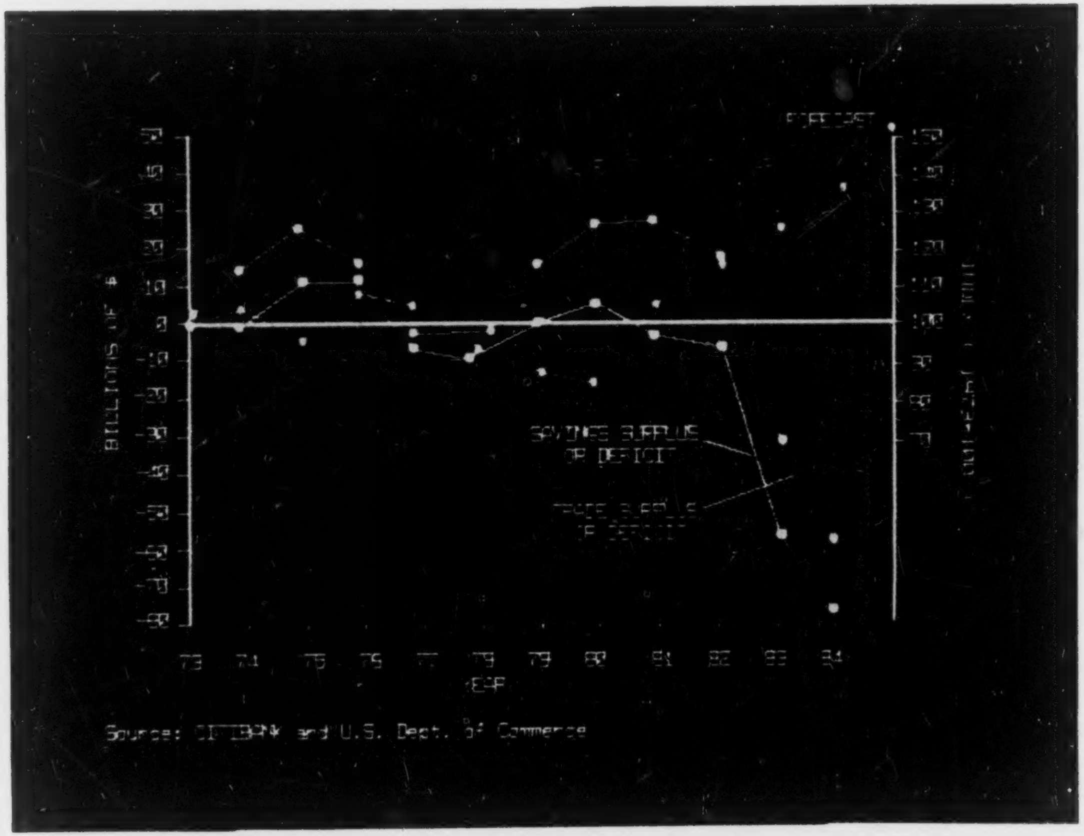
Source: CITIBANK

CHART 1



Source: U.S. Dept. of Commerce

CHART 2



Source: CITIBANK and U.S. Dept. of Commerce

CHART 3

PEPSICO INC.
PURCHASE, N.Y. 10577

Statement of

PEPSICO, INC.

JAMES M. DITKOFF
VICE PRESIDENT - TAXES

on

THE PRESIDENT'S TAX REFORM PROPOSAL

Submitted for the Record to the

COMMITTEE ON FINANCE
UNITED STATES SENATE

July 18, 1985

PEPSICO
PURCHASE, N.Y. 10577
TEL. (914) 253-2350

JAMES H. DITKOFF
VICE PRESIDENT - TAXES

PEPSICO RESPONSE TO PRESIDENT REAGAN'S TAX REFORM PROPOSALS

PepsiCo's principal operating divisions, Pepsi-Cola, Frito-Lay, Pizza Hut, and Taco Bell, serve customers throughout the United States and in 148 foreign countries and territories. With over $8 billion in annual sales, we are ranked number 40 on the Fortune 500 in terms of revenues, and with 150,000 employees, we are ranked number 11 in terms of employment.

With one important exception, PepsiCo enthusiastically supports the President's corporate tax reform proposals. Our specific responses to the more important provisions are as follows:

- WE SUPPORT the prospective repeal of the investment tax credit and ACRS depreciation, in the context of a revenue neutral tax reform bill, in return for a lower corporate tax rate which will benefit all segments of American industry and not just those that are capital intensive. In fact, we would support the much less generous depreciation proposals in Treasury I if the additional revenues could be used to defend, and accelerate the effective date of, the lower corporate tax rate.

In answer to those critics who claim that investment credits and accelerated depreciation are necessary to encourage certain types of investments in productive assets, we would argue that any investment whose economic viability depends upon a tax subsidy obtained at the expense of other taxpayers should probably not be made in any case.

- WE SUPPORT the provision to reduce the double taxation of corporate earnings distributed to shareholders. Although the provision would allow only a 10% deduction for dividends paid, and that deduction would not be effective until 1987, we believe that it will help to establish a valuable precedent which can be expanded in the future.

- WE SUPPORT the various provisions to measure income properly, including the new restrictions on the use of the cash method of accounting and the repeal of the reserve method for computing bad debt deductions. In fact, our only concern is that these provisions do not go far enough in expanding the tax base to include other forms of economic income which are now deferred for certain privileged industries, and we would urge Congress to consider the prospective repeal of both the intangible drilling cost deduction and the completed contract method of accounting.

- WE SUPPORT the alternative corporate minimum tax as a means of assuring that all profitable corporations share some meaningful portion of the corporate tax burden. For this reason, we urge Congress to add the following three items to the list of tax preferences, if the first two are not repealed outright, as recommended above:

    - 100% of the excess of intangible drilling cost deductions on successful wells over the amount that would have been deductible under cost depletion.

    - 100% of the excess of taxable income that would have been computed under the percentage of completion method of accounting for long-term construction contracts over the amount actually reported under the completed contract method.

    - 100% of the excess of CCRS accelerated depreciation over the amount that could have been deducted under straight-line economic depreciation with indexing.

  These additions would broaden the tax base without creating economic hardship, as all three of these tax preferences are elective. Thus, a corporate taxpayer can avoid the alternative minimum tax on these items in any given year by simply electing not to claim the tax preference for wells drilled, contracts commenced, and depreciable assets placed in service in that year.

We also question whether it is necessary to allow foreign tax credits to offset the alternative minimum tax on a dollar for dollar basis, or whether it would be adequate to allow foreign taxes as a deduction in computing the income subject to the alternative minimum tax.

- WE SUPPORT the grandfathering of existing tax benefits in Puerto Rico under Section 936 during a transitional period of at least five years. We strongly believe that the existing Section 936 can be defended on economic, social, and foreign policy grounds. If it becomes a foregone conclusion that legislative changes will be made, however, we believe that the President's proposal offers a statesmanlike compromise which will allow existing manufacturers in Puerto Rico to receive an adequate return on their investments while other options are being tested.

- WE SUPPORT the per country limitation on foreign tax credits. This is a matter of simple equity. If Americans will not be allowed to deduct state income taxes on their federal income tax returns, it makes no sense at all to subsidize the treasuries of foreign countries with higher tax rates than ours, by allowing a dollar for dollar offset against U.S. tax liabilities for the excessive taxes paid to those countries.

We reject the argument that an overall limitation on foreign tax credits is necessary to enable American companies to compete effectively overseas. If a local manufacturer in a foreign country is taxed at his country's high effective tax rate, why should an American manufacturer in that same country enjoy a 33% effective tax rate?

o WE OPPOSE the retroactive recapture of ACRS depreciation deductions. As the attached memorandum explains in more detail, this provision is discriminatory, inequitable, and inconsistent with its own underlying assumptions. Moreover, there are more equitable ways to replace the $58 billion in revenues which ACRS recapture would generate, including the $32 billion which Treasury I would have raised by repealing intangible drilling cost deductions and the $176 billion in additional revenues which Treasury I would have produced by allowing less generous depreciation deductions in the future.

However, our most important objection to this provision is that its retroactivity destroys all of the growth incentives in the President's plan by making it impossible for businesses to rely on the enacted laws of their elected representatives.

PEPSICO INC
PURCHASE N Y 10577
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JAMES H. DITKOFF
VICE PRESIDENT - TAXES

SUMMARY OF
PEPSICO RESPONSE TO PRESIDENT REAGAN'S TAX REFORM PROPOSALS

PepsiCo's principal operating divisions, Pepsi-Cola, Frito-Lay, Pizza Hut, and Taco Bell, serve customers throughout the United States and in 148 foreign countries and territories. With over $8 billion in annual sales, we are ranked number 40 on the Fortune 500 in terms of revenues, and with 150,000 employees, we are ranked number 11 in terms of employment.

With one important exception, PepsiCo enthusiastically supports the President's corporate tax reform proposals. Our specific responses to the more important provisions are as follows:

- WE SUPPORT the prospective repeal of the investment tax credit and ACRS depreciation, in the context of a revenue neutral tax reform bill, in return for a lower corporate tax rate which will benefit all segments of American industry and not just those that are capital intensive. In fact, we would support the much less generous depreciation proposals in Treasury I if the additional revenues could be used to defend, and accelerate the effective date of, the lower corporate tax rate.

- WE SUPPORT the provision to reduce the double taxation of corporate earnings distributed to shareholders. Although the provision would allow only a 10% deduction for dividends paid, and that deduction would not be effective until 1987, we believe that it will help to establish a valuable precedent which can be expanded in the future.

- WE SUPPORT the various provisions to measure income properly, including the new restrictions on the use of the cash method of accounting and the repeal of the reserve method for computing bad debt deductions. In fact, our only concern is that these provisions do not go far enough in expanding the tax base to include other forms of economic income which are now deferred for certain privileged industries.

- WE SUPPORT the alternative corporate minimum tax as a means of assuring that all profitable corporations share some meaningful portion of the corporate tax burden.
- WE SUPPORT the grandfathering of existing tax benefits in Puerto Rico under Section 936 during a transitional period of at least five years. We strongly believe that the existing Section 936 can be defended on economic, social, and foreign policy grounds. If it becomes a foregone conclusion that legislative changes will be made, however, we believe that the President's proposal offers a statesmanlike compromise which will allow existing manufacturers in Puerto Rico to receive an adequate return on their investments while other options are being tested.
- WE SUPPORT the per country limitation on foreign tax credits. This is a matter of simple equity. If Americans will not even be allowed to deduct state income taxes on their federal income tax returns, it makes no sense at all to subsidize the treasuries of foreign countries with higher tax rates than ours, by allowing a dollar for dollar offset against U.S. tax liabilities for the excessive taxes paid to those countries.
- WE OPPOSE the retroactive recapture of ACRS depreciation deductions, because it is discriminatory, inequitable, and inconsistent with its own underlying assumptions. Moreover, there are more equitable ways, which we are prepared to describe in detail, to replace the revenues which ACRS recapture would generate. However, our most important objection to this provision is that its retroactivity destroys all of the growth incentives in the President's plan by making it impossible for businesses to rely on the enacted laws of their elected representatives.

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ACRS RECAPTURE

When Congress enacted the Economic Recovery Tax Act of 1981 (ERTA), it created the Accelerated Cost Recovery System (ACRS). This depreciation method allows taxpayers to write-off the cost of most machinery and equipment for income tax purposes over a period of five years at a slightly accelerated rate. The purpose of ACRS was to encourage capital investment in productive assets, and it is generally believed that ACRS and other provisions of the 1981 Act contributed significantly to the economic recovery which followed.

Although ACRS probably could be used to calculate the depreciation expense in a company's financial statements under some circumstances, most companies depreciate their machinery and equipment for financial reporting purposes on a straight line method over the equipment's estimated useful life. Thus, tax depreciation will typically exceed accounting depreciation during the first few years of a productive asset's life, and then accounting depreciation will exceed tax depreciation. In both cases, however, the tax depreciation and the accounting depreciation are ultimately equal.

Suppose, for example, that a taxpayer purchased state-of-the-art industrial process equipment with an expected useful life of 20 years for $120 million on June 30, 1981. Under ACRS that equipment would be fully depreciated at the end of 1985. Suppose, however, that the guideline life of that equipment is 12 years for purposes of computing earnings and profits.

Under the President's tax proposal, 40% of the depreciation that could not have been deducted during the five years ending June 30, 1986, if the taxpayer had been allowed only straight-line depreciation over the guideline life, must be added to his taxable income in the years 1986-1988. This will increase his tax liability by $3.3 million in 1986, $2.8 million in 1987, and $3.7 million in 1988, even though he claimed no more depreciation than the amount he was legally entitled to claim under the laws in effect in those earlier years. The provision would apply whether or not the asset is still producing income and regardless of its remaining useful life.

The President's proposal correctly states that those who claimed ACRS depreciation over the past five years, when it produced a 46% federal income tax benefit, expected to forego a tax benefit at the same rate when financial accounting depreciation exceeded tax depreciation in the future. Hence, they provided deferred taxes in their financial statements at a 46% rate. Thus, if the corporate tax rate is reduced to 33%, and the Financial Accounting Standards Board (FASB) approves the use of the "liability method" for computing and recomputing deferred taxes, these taxpayers will be able to write-off a large portion of the deferred tax liability recorded on their balance sheets.

However, this is a mere accounting convention, which has no effect on corporate cashflows and no effect on the Federal Treasury. Moreover, it applies equally to those oil and gas producers who claimed intangible drilling cost (IDC) deductions. If there is an objection to this possible accounting "windfall", it should be presented to the FASB and not dealt with through a retroactive penalty tax.

The ACRS recapture proposal promotes still another fallacy with the claim that "a reduction in tax rates for the later years produces an unexpected benefit for the taxpayer by reducing the tax that must be repaid relative to the tax that was deferred". Depreciation is only repaid when a productive asset is sold for more than its depreciated tax basis. The fact that a taxpayer claimed all of its depreciation deductions on a given asset before a rate change occurred, rather than spreading them out over the asset's useful life, does not mean that he owes the Treasury anything if he was acting in accordance with the depreciation rules and regulations prevailing at that time.

Suppose, however, that the taxpayer in the previous example sells his ACRS equipment for $50 million in 1987. If the taxpayer recaptures $50 million of depreciation deductions in this sale at a 33% tax rate, when the original depreciation deductions produced a 46% tax benefit, there is something of a windfall. But the way to address this "windfall" is to make the depreciation recapture on such sales taxable at the rate prevailing when the depreciation was deducted. Similarly, however, the IDC recapture on sales of producing oil and gas wells should be taxed at the rate prevailing when the IDC was deducted.

Alternatively, if the property is not sold, but it is still deemed necessary to punish the taxpayer for exercising his right to claim ACRS depreciation, then 40% of the "excess" depreciation should be spread over the property's remaining economic useful life (or the guideline life where the remaining economic life cannot be determined), rather than an arbitrary three years.

The Treasury claims that this arbitrary three-year period is required solely to avoid unnecessary complexity. However, the income stream from certain investments in productive assets, such as ERTA's "safe harbor" tax leases, can be determined with pinpoint accuracy. Thus, a taxpayer should at least be allowed an election to have his future net income from these investments taxed at a 46% rate in lieu of ACRS recapture. Since the taxpayer would have the burden of isolating the income from these investments, the complexity would not be borne by the Treasury. Moreover, such an election would help counter the argument that Treasury proposed ACRS recapture to cover a revenue shortfall, with no consideration of tax equity whatsoever. Again, however, neutrality demands that IDC be treated the same as ACRS. Thus, the net income from oil and gas wells drilled over the past five years should also be taxed at a 46% rate, if this alternative is adopted.

It should also be recognized that intangible assets enjoy an identical "windfall" when tax rates are lowered. To the extent that a taxpayer has deducted research and development, advertising, manpower training, preventive maintenance, and other expenses-at a 46% rate, he is also enjoying the same "windfall" when those expenditures produce future income which is taxed at a 33% rate. This is even true of IRA and Keogh plan deductions. To the extent that an individual taxpayer has deducted his contributions to such plans when his marginal federal tax rate was 50%, he is also getting a "windfall" if his retirement benefits from those plans will be taxed at a 35% marginal federal tax rate.

Again, however, the most striking example is IDC. Most taxpayers' costs incurred in drilling and preparing oil and gas wells (including labor, fuel, materials, technical services, and even some related construction costs) are deductible as soon as they are incurred. They are not spread out over the economic useful lives of the wells, or even over five years as in ACRS. Hence, where these IDC deductions have produced a 46% tax benefit, the Treasury might well be justified in citing the 33% tax rate which will now be applied to the profits from these wells as a windfall. However, this is not what has been proposed. Treasury's original proposals would have spread future IDC deductions over the useful lives of the wells to which they pertain. However, the current proposals leave the instantaneous deduction of IDC intact, with only 8% of future IDC deductions being treated as a tax preference, which is potentially (though not necessarily) subject to a 20% alternative minimum tax.

This is certainly a gross inequity. If the only tax penalty for claiming instantaneous IDC deductions is that 8% of those deductions will be treated as tax preferences in the future, then ACRS should be retained, and 8% of future ACRS deductions should also be treated as a tax preference. On the other hand, if it is right to impose a tax over the next three years on 40% of the accelerated ACRS depreciation deductions claimed over the last five years, then 40% of the excess of IDC deductions claimed during the past five years, over the amounts that could have been claimed as cost depletion, should now be taxed to oil and gas producers over the next three years.

While the Administration proposal attempts to justify this huge tax subsidy for oil and gas producers on a national security basis, the supporting arguments do not withstand analysis. Oil and gas exploration in this country has fallen off in recent years because of a worldwide oil glut which has lowered prices, and not because of inadequate tax incentives. Another factor in the decline in domestic oil and gas exploration is that major producers have found it cheaper to obtain domestic oil and gas reserves by acquiring their competitors, and financing those acquisitions with junk bonds, whose interest has been fully deductible at a 46% tax rate. Yet this is not addressed at all in the Administration proposals, even though there have been several bills in recent years which would have limited interest deductions for corporate acquisitions.

In fact, the only defensible argument for singling out ACRS depreciation for a retroactive penalty tax is that it would raise $58 billion. However, there are two obvious answers to this statement.

First, it is up to the Treasury to propose equitable tax laws with prospective application. The burden should not be shifted to aggrieved taxpayers to replace the revenues that the Treasury would raise with an inequitable, retroactive tax proposal. Suppose, for example, that Treasury had proposed to tax all Social Security and Medicare payments. This, too, would raise a great deal of revenue, but we would certainly not tell our senior citizens that they must live with such a provision unless they can devise an alternative revenue source.

Second, the necessary revenues can be raised, consistent with the fundamental spirit of the Administration initiatives, by eliminating two of the Internal Revenue Code's tax preferences on a prospective basis:

- If the revenue estimates in Treasury I were accurate, the prospective repeal of IDC deductions would raise $32 billion over five years. This is 55% of the revenue which ACRS recapture would have produced.

- In addition, we suspect that the prospective repeal of the completed contract method of accounting would make up most of the balance of the revenue loss. According to an article in the June 18 edition of The Wall Street Journal, five of the nation's six biggest defense contractors paid virtually no income taxes at all during the years 1981-1983, largely because of the long-term tax deferrals they enjoyed under completed contract accounting.

- Finally, if there is any additional revenue shortfall after closing these two big loopholes, it should be made up by moving the proposed CCRS depreciation system, which would raise only $37 billion over five years, back in the direction of Treasury I's economic depreciation with indexing, which would have raised $213 billion over the same time frame. This would remove the Internal Revenue Code's remaining bias in favor of capital-intensive industries, while producing enough additional revenues to protect the lower corporate tax rate which is the most important stimulus to investment and economic growth.

These alternative revenue sources have ample economic justification, which cannot be found in the case of ACRS recapture, and they would eliminate unjustifiable concessions to certain industries.

In the final analysis, however, it is not the lack of economic justification that makes ACRS recapture unacceptable. It is rather the retroactivity of a provision which punishes taxpayers for relying on the tax incentives enacted by a previous Congress. The final sentence of the ACRS recapture proposal states, "The recapture rule applies only to old capital, and thus it has no effect on the cost of capital for new equipment".

In other words, this provision will not discourage new capital investments, because it penalizes only those who relied on the Economic Recovery Tax Act of 1981 to make such investments in the past, and now cannot take them back, even though the economic assumptions behind those investments have been invalidated after the fact. The same argument could be made for recapturing past years' IDC deductions. If taxing past depreciation deductions on machinery and equipment will not discourage future investments in such assets, then taxing IDC deductions claimed in the past should not discourage future oil and gas exploration.

However, if the Congress can retroactively repeal the tax legislation which it approved in 1981, then who can believe that the same thing will not be done two years hence? Who can believe that the 33% tax rate now offered as a trade-off for the loss of investment credits and ACRS depreciation will not be revoked retroactively when it is determined that there is another revenue shortfall of some sort?

In summary, we hope the Congress will agree that singling out one class of deductions, and subjecting them to a retroactive penalty tax, is not the proper way to reform the corporate tax system.

RCA Communications, Inc | 30 Rockefeller Plaza | New York, NY 10020 | Tel (212) 621-6057

RCA

Eugene F Murphy
Chairman and
Chief Executive Officer

Hon. Bob Packwood, Chairman
Committee on Finance
219 Senate Dirksen Office Building
Washington, DC 20510

Dear Mr. Chairman:

November 4, 1985

RCA Communications, Inc. would like to submit this letter for the record of the Committee's October 2 hearings on Tax Reform's Effect on American Business and Impact on Foreign Tax Provisions.

RCA Communications has overall management responsibility for the RCA telecommunications service companies, including RCA American Communications, Inc. (RCA Americom). RCA Americom has been authorized by the Federal Communications Commission to construct and launch three Ku-band satellites. The first and second of these satellites will be launched by year-end 1985, and we anticipate completing construction on the third satellite in the 1987-88 timeframe. Because this program was initiated based on assumptions that certain provisions of the present federal tax system would remain in effect, it would be adversely impacted by any revision of those provisions of the tax laws. Therefore, if there is to be any tax revision, it must be accompanied by fair transitional provisions.

The Importance of the Ku-Band Program

Domestic communications satellites have dramatically transformed telecommunications and have enhanced the U.S. leadership position in high-technology enterprises. We expect RCA Americom's Ku-band satellites to introduce further, equally sweeping changes. Because Ku-band satellites do not share the spectrum with domestic services, earth stations need not be located in situations remote from users. More significantly, rather than the large earth-stations associated with C-band satellites, Ku-band satellites can operate in conjunction with small, inexpensive rooftop antennas. The number of applications to which Ku-band services can be applied is therefore nearly limitless.

RCA Communications is in the process of investing over $350 million in the Ku-band program. Since this program was committed to in 1983, it was configured on the assumption, which was entirely reasonable then, that certain tax incentives would be available, particularly investment tax credits and accelerated cost recovery. Moreover, in developing a market for these new services, we assumed at the time of deciding to embark on this project that we would be able to transfer tax credits in qualifying leases to customers. As the Committee may be aware, even apart from the planning stages, satellites have extremely long lead-time. Construction times alone average three years. Accordingly, in order to meet launch deadlines, we have completely constructed the first two spacecraft; and just recently let contracts to begin construction on the third, which we anticipate will not be completed and be ready for launching until the end of 1988 or early 1989.

Impact of the Ways & Means Proposals

The proposals before the House Ways & Means Committee would not only cast doubt on these assumptions but also may undermine the economic foundations of a successful Ku-band program. Although we have initiated construction on all three satellites in the Ku-band program prior to the proposed September 26, 1985 cut-off for transitional rule protection, we are especially concerned whether investment tax credits would be available on the third satellite, since the transitional rule requires that properties under Asset Depreciation Rules Class 3 (which includes communications satellites) must also be placed in service by January 1987 -- and it will be virtually impossible even to complete construction on the third satellite by then.

Even if investment tax credits are available for these satellites, whether we could transfer the credits to qualified lessees remains uncertain. The Ways & Means proposals do not even address the transferability of tax credits except where property is sold and leased back. The availability of tax credits is often critical to the decisions of potential satellite users to select these carriers. Yet, because it has been the practice of users of communications satellites not to commit to use them until at least a satellite is built and more frequently until a market has developed for that satellite service, a more realistic date than September 25 must be selected as the effective date for commitments to use satellites that qualify for transfer of investment tax credit to the users.

In sum, while we would prefer that the present means of capital recovery remain in full force, we will let others make that case. We believe that, at the very least, communication satellites should be allowed to qualify under the transitional rule if placed in service by June 30, 1989.

This could be achieved by placing communications satellites in Asset Classes 5 and 6 and extending the date for placement in service of such assets from January 1, 1988 to June 30, 1989. Although communication satellites do not have as long an economic life as Asset Classes 5 and 6, they share in common a long construction period and should therefore be treated the same for the "placed in service" requirement under the transitional rule. In addition, because of the considerations detailed above, the date of placement in service should be extended, at least for communications satellites, until June 30, 1989.

Sincerely yours,

Eugene F. Murphy

cc: All Committee Members
Sen. Robert J. Dole
Sen. William V. Roth, Jr.
Sen. John C. Danforth
Sen. John N. Chafee
Sen. John Heinz
Sen. Malcolm Wallop
Sen. David Durenberger
Sen. William L. Armstrong
Sen. Steven D. Symms
Sen. Charles E. Grassley
Sen. Russell B. Long
Sen. Lloyd Bentsen
Sen. Spark M. Matsunaga
Sen. Daniel Patrick Moynihan
Sen. Max Baucus
Sen. David L. Boren
Sen. Bill Bradley
Sen. George J. Mitchell
Sen. David Pryor

WRITTEN STATEMENT
OF
THE SCIENTIFIC APPARATUS MAKERS ASSOCIATION
ON TAX REFORM ISSUES

PRESENTED TO
THE SENATE FINANCE COMMITTEE

October 3, 1985

The Scientific Apparatus Makers Association (SAMA) is pleased to present its views on the President's tax reform proposal and tax reform in general.

Founded in 1918, SAMA is the national representative of the high technology scientific, medical and industrial instrument, laboratory apparatus and electronic controls industry. Its 200 member companies, many of small or moderate size, manufacture and distribute more than 40,000 types of high technology precision instruments and related products. This equipment is used in research, measurement, analysis, testing and control by Government, industry, education, public utilities, and health care professions. SAMA's members have combined annual sales in excess of $14 billion. Forty percent of these sales are shipped internationally. Member companies have facilities in virtually every state, and employ more than 250,000 workers.

SAMA members already pay more than their fair share of U.S. taxes in comparison to other industries. A 1984 study by the Joint Committee on Taxation revealed that the instruments industry, on the average, paid an effective U.S. tax rate of 32.8% on U.S. income in 1983, and a worldwide effective tax rate on worldwide income of 36.7%. Its U.S. effective tax rate ranked in the top 5 (and less than 3 percentage points behind the highest rate) of the 31 industry groups studied and almost twice the average rate of all companies studied.

SUMMARY OF POSITION

SAMA supports and endorses the Committee's efforts to refine our Federal tax code to promote fairness, economic growth and competitiveness in world markets. This last goal is especially important to industries such as ours that are heavily dependent on overseas sales. However, as we strive to achieve industrial competitiveness, it is important to keep in mind one of the key conclusions drawn by the President's Commission on Industrial Competitiveness. The Commission, which completed its work in December 1984, concluded that there is no single means to assure that U.S. industries will be able to effectively compete in world markets. The Commission recommended that governmental actions should help to create, apply and protect technology, to reduce the cost of capital to American industry, to develop a more skilled, flexible and motivated work force, and to make trade a national priority. All of these areas are important. Therefore, we encourage this Committee as it considers the President's tax proposals, to ensure that the tax laws are amended to enhance rather than diminish U.S. industrial competitiveness.

SAMA supports tax reform to achieve the following goals:

1) Reduce the maximum corporate tax rates;

2) Stimulate research activities and the development of new and innovative technologies;

3) Encourage markets for high technology equipment such as instruments by providing a capital cost recovery system that recognizes the short-lived nature of those products; and

4) Assist U.S. companies to compete in world markets.

The President's tax reform plan goes a long way toward achieving these goals. However, as set out below, we recommend that the Committee make certain important changes:

I. REDUCE CORPORATE TAX INCENTIVES

We are pleased that the President's tax reform plan would reduce the maximum corporate tax rate from 46% to 33%. As documented in the Joint Committee's study of 1983 effective tax rates, the current tax law has produced a tax system in which there is a wide disparity in effective tax rates among industries. It also has resulted in high technology industries such as our paying among the highest effective rates. We support efforts to level out the wide disparity in corporate effective tax rates. However, it is imperative that as the Committee looks for ways to broaden the tax base, while preserving productive incentives like the research and development tax credit, it use the additional revenue to lower the maximum corporate rate to 33%.

II. INCENTIVES FOR RESEARCH AND DEVELOPMENT

It is vitally important the the Research and Development tax credit, scheduled to expire at the end of 1985, be extended and made a permanent part of our tax code.

Although there are numerous reasons for U.S. companies to invest in research and development activities, it is both necessary and appropriate for the government to provide additional stimulants. Congress recognized this in 1981 when it devised the Research and Development tax credit. Prior to that time, domestic research spending as a percent of gross national product declined by 10%, reaching a low of 2.23% in 1977-78. At the same time, with the aid of government incentives, both Japan and West Germany increased their R&D spending as a percent of GNP by at least 20%. Thanks in part to the R&D credit, this trend is being reversed. In 1983, U.S. research spending at a percentage of GNP is estimated to be 2.65% - about equal to that of Japan and West Germany.

Our Industry's Experience

A review of our industry's experience illustrates how research spending has significantly increased since the R&D tax credit was passed in 1981. Research spending in the instruments, measuring devices and process controls industry increased by 63% between 1980 and 1984. According to a survey conducted by Business Week magazine and based on information reported to the Securities and Exchange Commission, research spending by the largest companies in our industry rose from $578 million in 1980 to $942 million in 1984, a gain of 63%. For the first time, research spending actually rose during a recession. Sales were up from $13.1 billion to $15.7 billion, or 20% between 1980 and 1984. However, despite this increase in sales, research spending a percent of sales increased by almost 45% during this time. We believe that the actual increases for our industry are even higher. The Business Week statistics do not take into account small and medium size companies whose research spending is growing faster than the industry average. It should also be remembered that these figures relate to the period when the credit was being phased-in.

We believe the R&D tax credit is one of the important reasons for the recent growth in research spending. A survey conducted by the University of Pennsylvania economists confirms that research spending in the instruments and measuring devices industry would have been lower - by 3.7 and 5.9% respectively - in 1982 and 1983 without the R&D credit.

The Economic Impact and Foreign R & D Incentives

A number of studies have attested to the need for an R&D stimulant such as the R&D tax credit to achieve the optimum level of private research spending and to maintain our technological lead and competitiveness in world markets. One recent study, by Martin Bailey and Robert Lawrence (of the Brookings Institution) and by Data Resources, Inc. concludes that a permanent R&D tax credit would generate at least $1.2 billion of GNP growth within one year and up to $17.7 billion within five years. The authors further conclude that the long term economic growth produced by a permanent R&D tax credit would generate increased tax revenues that would more than offset the short term revenue cost of the credit.

Maintaining the R&D tax credit also is important to meeting the considerable tax and financial incentives that many foreign governments provide for commercial research performed within their countries. Attached to this statement is a summary of some of those incentives. In addition to providing additional leverage to corporate R&D managers in the competition for scarce corporate funds, the R&D credit by counterbalancing the importance of foreign incentives, encourages companies to conduct their research in the United States.

Extending the R&D tax credit also is consistent with fundamental tax reform. A recent Congressional Research Service study, finding that normal market forces discourage optimum investments in R&D and that it therefore "is appropriate for government to intervene so that socially valuable investment (in R&D) will be undertaken," also concluded that a reduction in corporate tax rates "may actually have a [further] negative impact on R&D investments and justify a retention or an increase" in the R&D stimulant.

The Need for a Permanent R&D Credit

We are pleased that the Administration recognizes the continuing need for an R&D incentive and has included a three year extension of the R&D credit in its tax reform proposal. However, we believe a three year extension is insufficient and will not achieve the long-term objectives of the credit. Many research projects take six to eight years, from conception to the beginning of commercialization. Making the R&D credit permanent would encourage companies to focus on longer term more innovative research programs. It also would allow better corporate strategic planning and result in more productive utilizations of corporate funds. In addition, it would send a clear signal to U.S. businesses that our nation is truly interested in sustaining our technological leadership. This is of critical importance especially when other nations are trying to attract our industries' research activities.

Deductability of Current R&D Expenditures

Although the President's tax reform proposal would not affect the current deductability of R&D expenditures, we oppose any change in Section 174. Current deductability of R&D expenditures should not be eliminated (or treated as a preference for corporate minimum tax purposes) for the following reasons. First, for financial accounting purposes, the current expensing of research and development costs is not only recognized as appropriate, but is required to clearly reflect the taxpayer's financial position. Thus, taxpayers cannot use R&D deductions to eliminate their U.S. tax liability while reporting profits to the SEC or their shareholders. Second, a review of pre-1954 law, the legislative history of the 1954 Code (in which Section 174 was enacted), and commentary on that legislation suggests that the resolution of uncertainty concerning the proper tax treatment of research experimental expenses was a primary objective of the Congress in enacting Section 174. Third, elimination of current deductability could result in a tax increase on high technology companies which already pay among the highest effective tax rates.

III. CAPITAL COST RECOVERY

An important factor is achieving the goals of tax reform and in sustaining economic growth is a capital cost recovery system which recognizes the true economic depreciation of our industry's products.

Reclassification of Instruments

Under the Accelerated Cost Recovery System (ACRS) instruments are depreciated over a five-year period. This is generally consistent with the depreciation of instrumentation for financial and book purposes of our major companies and slightly longer than their new product introduction cycles. Thus, the current ACRS recovery period, insofar as it applies to instruments, measuring devices and process controls, is not unreasonable or generous.

The Administration's proposed capital cost recovery system would place instruments in Class 3 and allow them to be depreciated at a 33% declining balance rate with a total recovery period of seven years. We believe this classification is inaccurate. Preliminary information that we have gathered reveals that our industry's principal products are economically and technologically obsolete within five years. That fact is reflected in their market values. Instrument appraisers, companies that lease instruments and others which buy used instruments and refurbish them, indicate that after five years, instruments generally have a market value of approximately 10% or less of their original value. This figure is not adjusted for inflation. These sources also disclose that major customers tend to replace instruments every 3-5 years due to technological obsolescence.

Physical deterioration due to continuous operation and constant exposure to deterioriating elements also contributes to rapid obsolescence of instruments. For example, many chromatographs used in the process control area operate 24 hours per day due to the lengthy start-up and recalibration time if they are turned off. Thus, they physically deteriorate and must be replaced in 3-5 years. This deterioration may be even further accelerated if the chromatograph is in constant contact with a corrosive or destructive material. Similarly, many optical coated instruments wear out within five years due to poor air quality and thus become completely inoperable.

Another option would be to place instruments in the same class as computers (currently Class II under the ACRS system) because of the similar technologies underlying both types of products. In fact, computers are an integral part of most modern day instrument systems and in many instances the value of the computer and companion software will be 40%-60% of the fair market value of the instrument.

The Administration proposes to establish a new office to study the economic value of assets over time. While this procedure would be helpful in the future if the Administration's depreciation system is adopted, it could take a substantial time before assets would be properly reclassified. In the meantime, the inappropriate treatment would be applied and there would be uncertainty and confusion over whether reclassifications actually would occur. More importantly, the misclassification will discourage business decisions to acquire these assets contrary to the intention that these decisions be based on non-tax considerations.

Where classifications in the Administration proposal are obviously wrong as in the case of instruments, Congress should not merely delegate reclassification authority to the Treasury Department. Rather, Congress should itself act on the best evidence available and establish its own generalized classification system to prevent the tax system from continuing to distort economic decision-making. Treasury could then make further adjustments through its studies where appropriate.

Accelerated Depreciation Recapture Tax

While we clearly do not support the accelerated depreciation recapture tax system proposed by the Administration, if is is adopted, it must be modified so that the benchmark against which actual tax depreciation is compared takes into account the short actual lives of high technology electronics equipment such as instruments. The use of a 12-year straight line period to measure excess depreciation will severely penalize our industry's customers and adversely affect our customers ability to acquire modern state-of-the-art equipment for some time because the money which otherwise would be used to purchase that equipment will instead go to pay the tax. Such purchases are necessary for our customers to maintain their technological lead and effectively compete in world markets. It also will result in significant amounts being subject to the windfall recapture tax where, in fact, no benefits were received under ACRS. As previously stated, the 5-year ACRS depreciation method closely approximates the true depreciation of instruments and should be used as the benchmark.

IV. TAXATION OF INTERNATIONAL OPERATIONS

The operations of many U.S. high technology electronics companies are international in scope. R&D efforts to develop new generations of products are so expensive that each new generation of products must be sold in the broadest possible marketplace to provide sufficient revenues to continue funding future product generations. Therefore, U.S. companies must sell their products competitively in foreign markets. If U.S. companies are not competitive, our balance of trade will further deteriorate. Furthermore, our foreign competitors will obtain the broader earnings base needed to finance increased R&D which will lead to the development of future generations of products.

For U.S. tax policy, the implications of the large export and international operations of U.S. high technology electronics companies are clear: the U.S. tax treatment of U.S. exports and the foreign operations of U.S. taxpayers are of fundamental importance. Without question, these rules can and do have a dramatic effect on the ability of U.S. companies to compete in international markets and, therefore, on the survival and prosperity of the industry. Given the need for U.S. corporations to be competitive in world markets, it is in this country's interest to encourage exports and not subject its corporations to a system of taxation that is substantially more restrictive than is faced by major foreign competitors. The Administration's proposed changes in the foreign provisions would significantly restrict the ability of U.S. companies to compete internationally which seems to us to be directly contrary to our nation's best interest, given the size and trend of our nation's trade deficit.

The Administration proposes the replacement of the existing overall foreign tax credit with a complex separate-basket, per-country limitation and changes in the rules for sourcing of income. In addition, the moratorium on allocation of R&D expenses under Section 1.861-8 also expires at the end of 1985 and no recommendation was made to make this provision permanent.

The Administration's position is that the net effect of these changes plus the reduction in the corporate tax rate will reduce the overall U.S. tax burden on foreign operations. Taken together, however, these provisions applied to recent tax returns of several of our members would have resulted in a significant tax increase on foreign income. These provisions will also result in significantly more complex tax administration that will impose compliance and audit burdens on taxpayers and the Internal Revenue Service.

Per-Country Limitation

This existing overall limitation to the foreign tax credit recognizes that the foreign operations of most companies are not strictly operated on a country-by-country basis, but rather are integrated regionally or worldwide. The overall foreign tax credit limitation enables U.S. companies to make decisions about the location and scope of their international operations with emphasis on the economic results overall, rather than with regard to the specific tax rules that apply in one country or another. Thus, the overall limitation improves the ability of U.S. companies to compete in international markets.

The Administration's proposal is in part premised on the concern that the per-country method is necessary to counteract tax incentives to locate investments in low-tax jurisdictions. According to the Administration, the need for the per-country method will be exacerbated if the domestic tax rate is reduced, since U.S.-based companies will need to generate a greater amount of lightly taxed foreign source income in order to utilize additional excess foreign tax credits. Instead of investing in the United States, it is feared, U.S.-based companies will invest in low-tax foreign jurisdictions.

The Administration's premise is seriously flawed. First, the foreign tax credit limitation primarily affects the reparation of foreign income, not investment. If profits from low-tax foreign countries cannot be averaged with those from higher tax jurisdictions, the tendency under a per-country approach will be to keep low-tax profits offshore indefinitely. Such an incentive to accumulate "locked-out" offshore capital could lead to more foreign, rather than U.S., investment under a "per-country" approach.

Our foreign competitors would not be so constrained regarding their capital flows. They can typically earn and repatriate profits from third countries without suffering home country income taxes. Both the free flow of capital and the worldwide competitiveness of U.S. based business should be encouraged and the proposed per-country limitation is a major step backward in achieving these national goals.

Second, under the overall method of limitation, decisions to locate factories and other operational activities are based upon many factors of which tax considerations are only one minor part. Among the substantial non-tax reasons for selecting manufacturing locations are the need for proximity to markets and sources of raw materials, availability of labor or skilled manpower, electricity, communications, transportation, political stability, government services, tariffs and many others. The experience of SAMA members is that non-tax considerations far outweigh tax considerations with regard to the location of most of the international manufacturing activites of U.S.-based companies under the overall method. Adopting a "per-country" limitation will make local tax considerations a more important element in plant site selections, contrary to the Administration's intention for proposing a "per-country" approach.

Third, Congress has specifically addressed potential abuses involving low-tax countries under the overall method. Investments which could be easily shifted to generate lightly taxed foreign source income, such as interest, are already subject to separate limitations.

Forth, implementation of a separate-basket, per-country limitation will greatly increase the complexity of the current law, which will add significant administrative expense to U.S. companies and to the IRS. The provisions on loss allocations will also add greatly to complexity, and to uncertainty, since future years' results will almost always affect prior years' returns.

The complexity that will arise under a separate-basket, per-country limitation will make it difficult for taxpayers to comply with the tax laws and for the IRS to audit them. It will be necessary to trace income and expense by country, source, and SIC code. and with new subjective tests introduced for sourcing income. Taxes will need to be allocated by source within a country and if a subsidiary pays taxes in more than one jurisdiction. Allocation of losses and the recapture of subsequent income would require the complete recomputation of tax returns of all foreign subsidiaries of a U.S.-based company many years after the tax returns are filed.

Furthermore, the more restrictions that are placed on the foreign operations of U.S. shareholders, the more likely it would be that U.S. companies, particularly small, rapidly growing companies, would decide to locate outside the United States or that foreign interests would acquire such companies. These companies could escape many of the U.S. tax constraints on international operations, such as Subpart F and taxation of foreign source earnings.

For the foregoing reasons, SAMA favors the retention of the overall foreign tax credit limitation.

Source of Income Rules

The President's proposal provides new rules for sourcing income. In particular, exports of products from the United States will usually be 100%

U.S. source, rather than in accordance with current law, which provides that export income is 50% foreign and 50% U.S. source. In addition, all sales to foreign affiliates and subsidiaries will be U.S. sourced under the proposal. Exports to countries where the U.S. exporter has no affiliates may be treated as 100% foreign source only if the exporter has a fixed place of business outside the U.S. which participates materially in the sale.

The Administration's proposal alters well-established tax principles for determining the source of income. The existing rule provides a fixed standard for dividing the profits from export sales between U.S. and foreign source income. Moreover, this rule encourages exports and improves the international competitiveness of U.S. companies by putting U.S. exports on a more equal footing with foreign exports.

The Administration's proposal, however, would substitute a rule which would arbitrarily make virtually all export income domestic sourced. There is no fundamental reason why this solution is preferable to the current rule. The exception allowed under the proposal for sales income attributable to a foreign, fixed place of business would turn on whether the fixed place of business "participated materially" in the sale. This standard substitutes a totally unworkable transaction-by-transaction, facts and circumstances determination for a clear, workable and auditable rule.

The proposed changes in the source of income rules would further complicate the application of the foreign provisions to multinational businesses engaged in a large number of transactions each year and could adversely affect the U.S. trade deficit. SAMA therefore urges the retention of the current rules regarding the source of export income.

R&D Expense Allocations under Regulation 1.861-8

SAMA is disappointed that the Administration has not proposed to extend beyond 1985 the moratorium on allocation of R&D expense to foreign income for purposes of Treasury Regulations Section 1.861-8. SAMA believes that this action constitutes a significant blow to the R&D efforts of U.S. business in that a failure to extend the moratorium amounts to a disallowance of a portion of R&D expense as a deduction for U.S. tax purposes.

Since 1981, both the moratorium on R&D apportionment and the R&D tax credit have been enacted. These provisions together have encouraged tremendous growth in the R&D conducted by SAMA members in the United States. If both of these pieces of legislation are not extended or made permanent, however, U.S. companies would need to consider seriously dramatic shifts of R&D activities to offshgore locations. This result is probably now more compelling than in 1981 because of favorable R&D incentives enacted since then in other countries, e.g., Japan, Canada, and France.

It is fundamental to realize that making the 1.861-8 moratorium on R&D expense permanent will not create any tax incentive to conduct R&D in the

United States, but rather will remove a substantial disincentive for doing so.

Moreover, extending the moratorium on allocation of R&D expense would be consistent with the amendment last year of Section 367(d). The effect of that amendment is to treat transfers of intangibles to a foreign corporations as taxable transfers generating U.S. source royalty or sales income at arms length rates. This change was intended to correct any perceived abuses arising in connection with the allocation of R&D expense.

SAMA believes that domestic R&D efforts should not be discouraged in the manner contemplated by the Administration and, accordingly, urge that the moratorium on R&D apportionment be made permanent.

Foreign Sales Corporations

The requirement of selling in foreign markets to remain competitive in the United States means that even relatively small high technology electronics companies export products to foreign markets. Many larger high technology companies are substantial exporters. Accordingly, SAMA supports the retention of the Foreign Sales Corporation provisions, which give U.S. companies favorable tax treatment for exports that are crucial to U.S. international competitiveness.

Puerto Rico

The President's proposal provides for the replacement of the current possessions income tax credit with a wage-based credit. The wage-based credit would be equal to the sum of 60% of the minimum wage and 20% of amounts paid between one and four times the minimum wage.

SAMA believes that the Administration's minimum wage credit proposal will be substantially ineffective in stimulating employment in Puerto Rico and the possessions and is otherwise undesirable for a number of reasons. First, low-wage industries have already largely abandoned Puerto Rico, and the minimum wage credit seems insufficient to reverse this trend. Second, high-wage industries, such as scientific apparatus makers, employ highly-educated and correspondingly well-paid employees in Puerto Rico. The proposed wage-based credit will not offset enough of such payroll and other operating expenses to be an effective incentive. Third, there are significant additional costs from operating in Puerto Rico, including freight, additional employee transfers, spcial power systems, etc. The proposed wage credit probably would not even cover such incremental costs. Fourth, a minimum wage credit does not encourage the use of subcontractors, suppliers, or services in Puerto Rico, as does the current credit. Such expenditures are as valid a contribution to Puerto Rican employment as directly paid wages.

If the Administration believes that the current credit contains potential for abuse, SAMA would prefer to see an attempt to correct the abuse.

CONCLUSION

As indicated at the outset, we support and endorse the Administration and the Committee's efforts to draft comprehensive tax reform legislation. However, at the same time, we believe it is important that a studied and deliberate approach be taken to tax reform, keeping in mind the potential impact on our nation's economy, jobs and our ability to effectively compete in world markets. We have attempted in our statement to assist the Administration and the Committee in their effort by providing our industry's views and priorities, and we look forward to working with both of them as the legislative process proceeds.

ATTACHMENT

R&D Tax Incentives of Major Foreign Countries

Japan. Japanese corporations undertaking R&D in Japan may deduct their current R&D expenses in full in the year in which such expenses are incurred, with a carryover of unused deductions for up to five years. Capital expenditures for R&D purposes must be depreciated over their useful lives, generally from four to seven years for R&D equipment. These capital expenditures also may be eligible for special depreciation, which allows an additional deduction in the year in which the asset is acquired.

Japan has also had a tax credit for R&D expenditures since 1966. The current tax credit applies to current R&D expenditures as well as to depreciation and overhead expenses. The credit is equal to 20 percent of the excess of current R&D expenditures over the largest amount of such expenditures incurred in any single prior tax year since 1966. The credit does not reduce the R&D deductions otherwise available. Recent press reports indicate that the Japanese government is seriously considering proposals to raise the credit rate to 25 percent and to lower the credit base.

In addition, Japan allows a special deduction of up to 40 percent of corporate income for firms that derive some portion or all of their income from "overseas transactions in technical services." For example, Japanese corporations may deduct 28 percent of the income derived from the sale of technology abroad in the form of patents and know-how. Finally, firms which export products are allowed special reserves -- deductible at rates 1-2 percent -- for the development of overseas markets.

South Korea. In South Korea, emerging as one of the strongest competitors of the U.S. high technology electronics industry in world markets, current expenditures for R&D may be deducted fully in the year in which they are incurred. While fixed assets used in R&D activity must be depreciated over their useful lives, companies in the electronics industry are eligible for the following additional depreciation allowances. Electronics companies, as one of Korea's targeted industries, are entitled to additional depreciation equal to 100 percent of normal depreciation. An investment credit on the cost of machinery and equipment (3 percent if imported; 5 percent if domestic) can be taken instead of the special additional depreciation allowance. A Korean corporation establishing R&D facilities is allowed either a one-time special depreciation allowance of 90 percent in the first year or a tax credit equal to 8 or 10 percent of the cost of the invested assets. A corporation investing in the further development of research results originated by certain research institutions may take either a one-time additional depreciation allowance of 50 percent of the invested assets or an investment tax credit of 6 or 10 percent. A corporation in the electronics industry also may take a tax credit equal to 10 percent of technology development and training expenses actually incurred, such as compensation paid to researchers, engineers, or research institutions. Finally, a Korean enterprise can set aside and claim as a deduction a special reserve for technology development in the greater amount of 1 percent of total revenue for the taxable year or 20 percent of taxable income. For the high technology-intensive industries, such as the semiconductor and computer industries the deductible reserve can be up to the greater of 1.5 percent of revenue or 30 percent of taxable income.

Taiwan. In Taiwan, another strong competitor of the U.S. electronics industry, current expenditures on R&D are deductible in the year in which they are incurred. Any equipment used in R&D that has a useful life in excess of two years must be depreciated. However, R&D equipment is eligible for accelerated depreciation, and equipment with a useful life of ten years or less may be depreciated within one-half of its actual useful life. In addition, machinery or equipment purchased by a technology-intensive enterprise is eligible for an investment tax credit of 15 percent in the case of domestically produced equipment and 10 percent of the acquisition cost in the case of imported equipment. Finally, Taiwanese technology-intensive industries are eligible for a special reduced corporate income tax rate of 22 percent.

United Kingdom. In the United Kingdom, current expenditures on R&D are fully deductible in the year in which they are incurred. In addition, capital expenditures incurred in R&D activities, including investments in machinery, equipment, and buildings used for research, are fully allowable as a deduction in the year in which such expenditures are incurred. Unused deductions may be carried forward for a period of up to five years. In addition, the British Government provides a system of direct grants for R&D projects.

West Germany. The Federal Republic of Germany provides for the deduction of current R&D expenditures from taxable income in the year in which they are incurred. While capital expenditures on R&D generally must be depreciated over the economic life of the assets, accelerated depreciation of R&D assets at rates of up to 50 percent over the first five years are permitted with respect to personal property. In addition, Germany provides a 20 percent direct cash payment (termed an "investment premium") on the first $170,000 (DM 500,000) and 7.5 percent on the balance spent in any given year on depreciable assets (including real property) used for R&D purposes. This tax credit does not reduce the amount of the R&D deductions that otherwise are available.

France. French tax law provides for the full deduction of current R&D expenses in the year in which they are incurred. Until recently, buildings used solely for scientific and technical research were eligible for a special accelerated depreciation allowance under which 50 percent of the cost of the building was deductible in the year of acquisition, with the balance being depreciated over the remaining useful life of the asset. In 1983, the special depreciation allowance was replaced by a 25 percent incremental tax credit very similar in structure to the U.S. R&D credit. In addition, France has adopted a generally applicable system of accelerated depreciation in the first year of service of the asset. Finally, France also maintains a system of cash grants for R&D under which companies creating or expanding scientific or technical research departments may be entitled to a (taxable) cash grant of 15 to 20 percent of the value of the expenditure made, up to a maximum of 25,000 francs per job created.

Canada. In Canada, immediate expensing for both current and capital expenditures for R&D purposes is allowed. Canada provides for an indefinite carryforward of excess R&D deductions. Canada also offers a 20% flat rate tax credit for R&D activities based on a firm's total R&D spending, including R&D expenditures. Canada's R&D credit is unique in reducing the R&D deductions correspondingly on a dollar-for-dollar basis. However, Canada also provides an additional allowance equal to 50 percent of R&D expenditures (both current and capital) which exceed a base period amount determined on the basis of the annual average of the preceding three years.

PROJECTED EFFECT THAT TAX REFORM WILL HAVE ON AMERICAN BUSINESS

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PROJECTED EFFECT THAT TAX REFORM WILL HAVE ON AMERICAN BUSINESS

Tax simplification is a popular notion sponsored by President Reagan and other Congressmen and Senators. Although the concept is sound, I feel that all the proposals thus far have short comings. Please consider:

1.) How many tax forms will this plan eliminate?

2.) How many Internal Revenue Service regulations will be deleted because of this plan?

3.) What will the effect be on our nations economy as the result of this plan?

It is my understanding that only four forms would be eliminated (1040 EZ; easy form, 3468; investment credit, and schedule W; marriage deduction for working spouse, schedule G; income averaging). There are 560 forms published by the I.R.S.

More I.R.S. regulations would be published constituting a more complex code.

Tax proposals in the past have been used to reflect changes in the economy. Keep in mind that violent changes in cost (taxes are a cost of doing business) have had deleterious effects upon our economy. Remember the oil crisis of the 1970's. Keep in mind business supports our government. Not vice versa.

Please note, that this return-free system will work only for those that have income or transactions reported to the government by third parties (i.e. wages, interest, dividends, I.R.A. contributions). Other tax payers will have to file (business, landlords, investors, capital gains).

Recently I have noticed that one newspaper columnist was appalled because 50 of the largest 500 corporations in America did not pay taxes last year even though they made a profit and 48 received refunds. I do not know who these corporations are but I know enough about taxes and from the information in this article that what happened was these corporations had losses in the previous year. Because of the tax law, corporations are not allowed to deduct these losses. Individuals can deduct business losses from other income such as salaries, corporations can, however, deduct previous years losses against current years income which can result in no tax liability. Justifiably so because in effect the corporation is recovering assets lost in one year and replacing them in another. A net loss results in a decrease in assets and net income increases assets.

Please note that only 10% of the top corporations were in this catagory any how.

There is a mistaken belief that all or most corporations and all or most wealthy individuals do not pay any taxes. It is simply not true, only a small percentage pay no taxes.

I do have reservations regarding the elimination of the investment tax credit. The purpose of this credit is to encourage businesses to invest in equipment with the hope of stimulating the economy and creating jobs. This is most beneficial to manufacturing companies. Since the U.S. manufacturers are the most vulnerable to foreign competition, thousands of manufacturing jobs have been lost and we have a huge foreign trade deficit, this may be a crippling blow to our industries.

U.S. businesses need to be more competitive in the U.S. and foreign markets. Other countries help their companies to compete in our economy. Let's be sure that we are not hindering our businesses.

I do not think that income averaging should be eliminated. This law is designed to help those individuals or businesses with wide fluctuations in income from one year to another. It is particularly important to cyclical businesses such as the construction industry. Or employees who have been out of work for an extended period of time due to economic conditions or injury.

I prepare taxes as part of my livelihood. I know how difficult the forms can be. Please consider my comments when presented with any tax proposal. You will then be able to make an intelligent decision on tax forms.

STATEMENT
# of the
UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

TO THE

COMMITTEE ON WAYS & MEANS

on

THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS
FOR FAIRNESS, GROWTH, AND SIMPLICITY

BY
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Chairman
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July 11, 1985

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS
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STATEMENT OF THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS BEFORE THE COMMITTEE ON WAYS AND MEANS

The U.S. Council for International Business is a New York-based business policy organization representing the views of 300 enterprises from the manufacturing and services sectors on issues affecting their ability to compete and operate effectively in international markets. The preeminent U.S. business association concentrating on international economic and social issues, the Council is the U.S. affiliate of the International Chamber of Commerce, the Business and Industry Advisory Committee to the OECD, and the U.S. secretariat for the International Organization of Employers.

The ability of U.S. enterprises to operate effectively and to compete with its foreign counterparts in the international marketplace is of ever increasing importance to the U.S. economy as the Administration looks to reduce the current deficit and position its industry to compete on an equal par with industry from the rest of the world.

The U.S. Council opposes several of the proposed changes, as outlined below, on the grounds that they will inevitably place U.S. companies at a severe competitive disadvantage vis-a-vis companies from other nations. This disadvantage would arise primarily because the per-country limitation would give an advantage to multinationals from Europe and Japan where foreign source income is either not taxed or a more generous foreign tax credit regime is in place. A move by the U.S. to a per-country limitation would further retard

U.S. overseas investment and consequently would negatively impact the U.S. balance of payments.

Per-country foreign tax credit limitation

The fundamental purpose of the foreign tax credit mechanism, which became law in 1918, is to eliminate international double taxation. Over the many years since original enactment, much legislative and regulatory tinkering with the mechanism has taken place, particularly with respect to the structuring of an appropriate limitation to ensure that the credit would not spill over against the U.S. tax on domestic income. We believe that the overall limitation, which was enacted in 1961 as an alternative to the then prevailing per-country limitation and which, in 1976, became the sole limitation, best reflects the realities of international business life (as will be further delineated below), despite the establishment of the various separate limitation baskets. In our opinion, the President's proposal that the foreign tax credit limitation be computed only on a per-country basis and that the overall limitation be repealed is not only conceptually ill-conceived, but will present taxpayers with a much more complicated regime than under present law and will increase the costs of compliance and audit by both taxpayers and the IRS. In addition, we suggest the very fact that this change would generate substantial revenue indicates the possible creation of double taxation, which the credit is dedicated to eliminate.

A number of rules have been put in place over the past 20 years to prevent abuse in the application of the "overall" foreign tax credit limitation. These include: (1) segregated income "baskets" for interest, oil and gas, and DISC/FSC, in addition to the catchall basket for all other income, (2) the deduction allocation and apportionment rules of Reg. Sec. 1.861-8, and (3) the 1984 Act's provisions that recharacterize certain types of income generated from foreign subsidiaries as U.S. source income and/or separate limitation interest income. Moreover, other sections of the Code (e.g., Subpart F) have been, and may continue to be, amended from time to time to prevent perceived abuses. As the coup de grace, the President's proposal includes new rules that, prospectively, would revise substantially the current rules for sourcing of sales of inventory, business personal property, and intangibles.

In effect, the proposals acknowledge that most, if not all, potentially artificial arrangements should be curtailed by the proposed amendments to the sourcing rules, which are intended to more closely track economic activities. The President's remaining concern is that the "overall" limitation encourages a misapplication of resources by U.S. multinationals. An apparent illustration of such a misapplication is the building of a manufacturing plant in Ireland to take advantage of that country's ten percent tax rate for manufacturing income. The thrust of this criticism is that a multinational corporation following this course of action is applying its resources in such a way as to benefit from a combination of tax advantages (i.e., the low Irish tax rate in conjunction with the ability to utilize otherwise excess credits from countries with relatively high effective tax rates) rather than applying such resources for its overall economic benefit (e.g., investment in the U.S.).

We do not believe that U.S. companies responding to Irish (or similar) incentives represent a misapplication of resources calling for corrective measures. In fact, tax incentives are only one element on the long list of decision-making priorities (e.g., infrastructure, labor, governmental stability, market access) of multinationals when selecting a location for a new facility. Accordingly, a plant placed in Ireland is one that would probably have been built elsewhere in the EEC. It may well have been sited in Ireland because of the tax advantage compared to other EEC nations. Such a plant rarely, if ever, would represent a substitute for a facility that would have been built in the United States.

It should be carefully noted that foreign competitors take advantage of such incentives (for example, using the Irish incentive tax rate to manufacture products for supplying EEC countries) and that many of such competitors, primarily from other industrialized countries, operate under home-country tax systems that neither tax foreign source income at all (i.e., territorial system) nor allow a foreign tax credit using either an overall limitation (e.g., Japan) nor a per-country limitation where the impact of such limitation is negated by permitting the use of third country holding companies to average the tax burdens of income from high- and low-tax countries (e.g., the United Kingdom, see attached exhibit). The use of a third country holding company for this purpose would be denied to U.S. taxpayers under the President's proposals.

The case for retaining the "overall" limitation is well stated by the 1977 report of the Ways and Means Committee's Task Force on Foreign Source

Income, chaired by the current chairman of the Committee on Ways and Means, Representative Daniel Rostenkowski. The report states, in part:

> "Under the overall limitation, a company averages together all of its foreign income and taxes from all foreign countries. Thus, an individual or company which annually pays taxes in one foreign country at a rate higher than the U.S. tax rate (and thus would have some tax credits disallowed under the per-country limitation) is able to average those taxes with any taxes which might be paid at lower rates in other foreign countries when applying the overall limitation.
>
> In many instances this averaging of foreign taxes would appear to be appropriate. Many businesses do not have separate operations in each foreign country but have an integrated structure that covers an entire region (such as Western Europe). In these instances a good case can be made for allowing the taxes paid to the various countries within the region to be added together for purposes of the tax credit limitation.
>
> An equally important consideration in comparing the overall limitation by itself with a combination of the per-country and overall limitations is the relative burden which each approach places on taxpayers and on the IRS. The per-country limitation requires that a separate computation be made for each country in which a taxpayer operates. Each of these computations requires the taxpayer to calculate the gross income and deductions to be allocated to each

> country. Since, as discussed above, many large corporations operate on an integrated basis in a number of countries, assigning the income and deductions to each of the various countries in which a corporation operates is often a complicated process leading to an arbitrary result. It constitutes a substantial burden for taxpayers and places the IRS in the difficult position of attempting (upon audit) to review a company's operations in every country around the world. These administrative and enforcement problems are greatly alleviated under the overall limitation since the only allocation of income and deductions that is required is between the United States and all other foreign countries as a group."

The reasoning of the Rostenkowski Task Force regarding the retainment of the "overall" limitation remains just as compelling today as when the report was initially issued. When considering it, one should note that the report originated with knowledgeable, experienced members of the primary tax writing committee of the Congress(1). Moreover, the Rostenkowski logic constitutes a strong and clear repudiation of the statement in the President's proposal "that the proposed changes will limit the foreign tax credit to its function of eliminating double taxation of foreign income."(2)

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(1)See also Testimony of William E. Simon before Committee on Finance, U.S. Senate, regarding the Tax Reform Act of 1975 (HR 10612) (MARCH 1976).

(2)The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, pg. 395.

With regard to complexity, it should be noted that the application of a per-country limitation in conjunction with separate "baskets" involving the tracing of income and deductions within each country and then within each basket within each country, will be so complicated that both taxpayer compliance and IRS audit capability will suffer tremendously. At the very least, a great deal of additional time, effort, and resources will be required to attempt compliance and enforcement. For each country in which activities take place, or income (loss) is generated (either directly or through a subsidiary or branch) operating results will have to be segregated into the various categories (e.g., catchall and separate limitation baskets), taxes paid with respect to each such category will have to be identified and expenses will have to be allocated and apportioned to each such category even if the allocation and apportionment rules are simplified as suggested in the President's proposal. If there are any per-country net losses, they must be apportioned among the profitable countries (including the U.S.), and if there are any turnaround countries (i.e., loss operations turned profitable) then such profits will have to be apportioned among the countries (including the U.S.) to which the losses were previously apportioned. In addition, any carryovers will have to be applied to each category within each country, as appropriate, and certain recharacterization concepts (e.g., the flow-through U.S. sourcing or flow-through Sec. 904(d) interest characterization) will have to be applied on this super-fragmented basis.

We wish to stress the overwhelming compliance burden to be encountered by a U.S. multinational with branch or subsidiary operations in 30 countries and with two-tier subsidiary structures in ten of these. If no losses or carryovers are involved, 30 per-country computations will be required, with a potential 40 Sec. 904(d) and 40 Sec. 904(g) flow-through computations. The complexities involved in this proposal are astounding. The President's proposal recognizes the significant new compliance burdens its foreign tax credit proposal would impose on taxpayers, yet is not dissuaded from urging its adoption.

We strongly believe that the complexity issue alone is sufficient to persuade Congress to retain the existing overall limitation approach. When viewed in conjunction with the conceptual weakness of the per-country approach, one is virtually compelled to reject the President's approach.

As noted above, the President's proposal contemplated sourcing income and taxes by country of origin irrespective of the country of incorporation of the corporation earning the income. Where substantial corporate tiering is involved, this rule compounds the initial complexity created by the proposed approach. The report recognizes the inequity where a corporation pays a residual income tax (after applicable double tax relief) to its country of incorporation or residence on income earned elsewhere because of the fact that the income will be ascribed to the source country while the associated income tax will be a home country levy. In this connection, the President's package proposes an election whereunder a portion of residual tax may be ascribed to the source country to prevent this mismatch. Nonetheless, this look-through sourcing concept injects further complications into an already overly complex scheme.

Although we strongly believe the per-country limitation is ill-advised and should be dropped from the reform package at the earliest opportunity, we also believe that some of the proposed technical changes should be retained, albeit in an overall limitation environment, i.e., ten-year carryforward, cumulative earnings and profits pools rather than annual pools, and the long needed integration of the Sec. 964 earnings and profits rules with the Sec. 902 accumulated profits rules.

Source of income limitation

The proposed rules would source income from sales of inventory and other personal property (including the portion of the income ascribed to the selling activity covered under Sec. 863(b)) where significant economic activities generating such sales took place, rather than where title passed. This would be deemed to be the taxpayer's country of residence unless the seller could demonstrate that an establishment abroad participated materially in the sale, in which case the country of the establishment would be the source country. Although the proposal attempts to source income in accordance with perceived underlying economic realities rather than on title passage, we see merit in retaining th well-established title passage standard, as it affords certainty and is based upon the economic reality of passage of risk. Additionally, many individual states focus on title passage for purposes of their income or franchise tax.

The proposed change--the introduction of a uniform rule for sourcing of income arising from the sale and/or licensing of intangible property--would be a constructive change and one that we thoroughly support.

Separate basket limitation

Portfolio interest is a type of income item whose source can be manipulated by the form of a transaction and, for this reason, the separate limitation interest "basket" probably deserves to be retained. We feel strongly, however, that the separate limitation concept should be limited to this type of item (including possible expansion to other portfolio income items as contemplated in the active/passive suggestion in the President's proposal). Creating a proliferation of separate basket limitation items would serve no policy purpose and would further compound the already intricate nature of the foreign tax credit provisions. In this regard, we urge that the separate "basket" for oil income (Sec. 907) be repealed (rather than being retained as suggested in the President's proposal), as the regulations under Sec. 901 (reg. Sec. 1.901-2 and Reg. Sec. 1.901-2A), together with Sec. 904(f), are totally adequate to prevent the treating of disguised royalties as creditable income taxes.

"80-20" corporations

In proposing the repeal of the "80-20" corporation exception to the normal sourcing rules, the President is attempting to have the best of two worlds. On the one hand, the Code retains the rules enacted in 1984 that characterize dividends and interest income from foreign corporations as U.S. source if the income can be traced back to U.S. sources. On the other hand, the President's proposal would repeal rules that are complementary to the 1984 changes which characterize dividends received from U.S. corporations as foreign source if the income can be substantially (80 percent or more of the payor's gross income over the preceding three-year period) traced back to foreign sources. This is totally inconsistent. The "80-20" company rules have been in place for many, many years, to facilitate legitimate financing of operations by U.S. companies. The likelihood of artificial arrangements affecting government revenues, which never has been a serious problem, will be of even less concern under the recently adopted and proposed sourcing rules. We suggest that the Administration would do well to drop this proposal.

Conclusion

In conclusion, we recommend that at the very least the proposed return to the per-country limitation in the Internal Revenue Code be abandoned as a misguided effort. The entire package is predicated on the notion of instilling "fairness, growth, and simplicity into the tax structure" yet the foreign tax credit proposal does not serve any of these purposes and, in some cases worsens the existing system. Accordingly, we believe the proposed changes in the foreign tax credit should be discarded. Moreover, we do not believe that retaining the present overall foreign tax credit limitation mechanism would disturb the balance of the entire reform package.

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WHIRLPOOL CORPORATION
COMMENTS ON FEDERAL TAX REFORM

Federal tax reform is a necessary step to achieve tax equity. Efforts to amend the federal tax code are long overdue. However, in spite of this need, Whirlpool Corporation believes that a matter of even greater national urgency is the imperative to control the growing budget deficit and mounting national debt. Measures to balance the budget should come first from spending reductions before other avenues are considered. Solutions must be enacted quickly to dispel the economic cloud that is inexorably building over our national prosperity and quality of life. Only after a plan on deficit and spending cuts has been agreed upon should Congress and the Administration take up the matter of tax reform.

I. Reduced Corporate Tax Rate Helps Spread Tax Load

Whirlpool has historically paid a large share of earnings to federal taxes, with an average annual effective rate of about 45 percent since 1974. The company strongly supports tax reform measures that champion a fair-share taxation policy. We believe that all citizens -- both individual and corporate -- who benefit from government services have an obligation to contribute a proportional share towards the taxes which fund the services rendered. It is our opinion that a modified flat tax approach, as outlined in President Reagan's plan, provides a useful starting point toward greater tax equity.

Whirlpool Corporation endorses President Reagan's proposal to reduce the corporate maximum income tax rate from 46 percent to 33 percent, but has qualms about the weaknesses of the minimum corporate rate with all its tax preferences.

II. The Case Against the Minimum Corporate Tax and Tax Preferences

The Administration's tax plan also proposes a minimum corporate tax. Its stated purpose is to assure that all corporations that receive government services meet their responsibility to pay their fair share of the tax burden. We support that concept, but feel the plan as written will never fully achieve that goal. Although a minimum tax may increase the number of corporate taxpayers, the host of special interest tax shelters and preferences still preserved in the plan will cause it to fall far short of a fair-share tax program.

We seriously question whether a corporate minimum tax concept should be part of any fair-share tax reform measure since its continued presence gives tacit approval that certain tax preferences are acceptable. A more equitable approach would be a lower rate with no tax preferences.

III. The ITC/ACRS, Business Investment and Tax Equity

We contend that one of the greatest stimulants for capital formation would be a lower effective tax rate -- e.g., the President's proposed reduction in the maximum corporate tax rate from 46% to 33% -- even if enactment of such a proposal would mean changes in the Investment Tax Credit (ITC) and the Accelerated Cost Recovery System (ACRS).

ITC and ACRS were designed to stimulate capital investment and plant modernization, match more realistically cost recovery with capital expenditures, and encourage job creation. Overall, we believe the economic recovery now underway corroborates that Congress's goals are being met. In spite of their successes, the ITC and ACRS programs were add-ons to the tax code rather than the product of a deliberative, comprehensive tax policy for economic growth.

Adoption of a new broad-based tax system like a reduced corporate maximum rate or flat tax plan would tend to provide a better long-term approach to address the needs of the emerging global competition. Equity in a corporate tax system would be better served by the flat tax rate approach which would broaden the base of corporate taxpayers, provide required levels of tax revenues, while assuring needed capital formation for re-investment.

IV. "Windfall" Tax on Past Depreciation is Objectionable

The Administration's proposal to tax past economic gains in depreciation dollars between ERTA's 1981 scheduled allowances and straight-line depreciation is most objectionable. Its enactment would unjustly penalize businesses for having made previous investment decisions based upon then prevailing tax policy.

> *We believe the Administration should drop its proposal to tax past "windfall" gains.*

IV. Employee Benefits Should NOT be Taxed

The President's plan would also change the tax treatment of a number of employee benefit programs. The three changes which we oppose are:

1. Lump sum pension distributions -- favorable tax treatment would be eliminated and early withdrawals would carry a penalty tax.

2. Section 401(k) plans -- Employer contributions for the account of employees would be capped at a maximum of $8,000 to be reduced by any employee contribution to an IRA account.

3. Taxation of health plans -- Employer-paid health contributions of $10 a month for individuals and $25 a month for families would be taxed to the employee.

Whirlpool's Benefit Programs

Whirlpool employs approximately 22,000 people nationwide, and provides its employees a broad range of benefits that cost the company tens of millions of dollars annually. Our benefit package includes, but is not limited to: group life, health and dental insurance ... retirement pensions ... savings and profit sharing ... education tuition reimbursement ... an Employee Stock Ownership Plan ... disability and unemployment insurance plans ... paid vacations and holidays, and a host of other benefits too numerous to itemize here. In most cases, these plans are extended at little or no cost to employees.

Benefit programs like these make our employees more productive since they know they are protected not only against relatively minor interruptions to their employment (e.g., short-term sicknesses), but against even catastrophic losses that threaten their families' well-being (e.g., life and major medical insurance).

Government Backing

The majority -- if not all -- of our benefit programs was developed by the company with strong encouragement from the federal government by means of favorable tax treatment. Congress rightly determined that government itself profits when employers, rather than the government, provide for benefit programs. Although privately funded benefit programs are directed only to a company's own employees and their families, they do, nonetheless, enhance the general welfare by reducing overall demand on taxpayer-funded programs (e.g., Social Security, Medicare, Medicaid, welfare, etc.).

Government support has become so successful, in fact, that today 90 percent of employees over age 25 with one year of service receive some form of employer-paid life and health protection. Over 70 percent are covered by a pension program. The value of private pension plans has increased dramatically in only 12 years: from $190 billion (1970) to $573 billion (1982). Clearly, private pensions and life and health plans have found favor with the American people, and coverage will likely continue to grow in the years ahead.

Yet, in spite of their growing popularity, private benefit plans are under attack by a number of so-called "public spirited" interest groups who are pressing for reform on two fronts: 1) alleged discrimination, and 2) foregone tax revenues. Those charging discrimination allege that private plans are biased to favor the more highly compensated, while women and lower income groups receive less favorable treatment. However, statistics released by the Employee Benefit Research Institute (EBRI) refute that charge:

1. Government data show 53 percent of retired married couples receive employer pension income, 33 percent of unmarried individuals do, and an additional 10 percent have received lump sum distributions. By 2007, based on recent pension coverage levels, the figures will be 82 percent of married couples and 58 percent of unmarried individuals.

2. Of full-time workers over 25, 72 percent are covered. Among older groups, the level is nearly 85 percent.

3. Three fourths of workers enrolled in pension plans in 1983 earned $25,000 a year or less. Of enrolled workers who had become vested, 70 percent were also in the category of $25,000 a year or less.

4. Coverage does not differ significantly between men and women who are full-time, full-year workers; 72 percent of the men and 66 percent of the women are covered. In 1982, women made up 42 percent of full-time workers and 40 percent of all those covered.

5. Health insurance coverage is spread across the income spectrum. More than 80 percent of those with health insurance earned less than $25,000 in 1983.

6. Government studies show that 75 percent of the tax value goes to those earning less than $50,000 per year.

7. Over their lifetime, workers repay, through income taxes on pension distribution, 86 percent of the nominal value of the deferred tax on pensions.

Those pressing for reform also charge that employer-funded benefits constitute up to 60 percent of payroll costs and, under today's tax code, escape taxation. (The figure for Whirlpool is 37.1 percent of payroll.) Again, closer analysis refutes that claim.

First, these groups bloat their figures by including every conceivable type of benefit in their list, including, among others, legally-mandated programs like Social Security, Medicare, and workers and unemployment compensation taxes; along with optional employer benefits like paid vacations and holidays, sick leave, rest periods, tuition reimbursement, group life and health insurance, and pensions, etc. Remove the cost of government-mandated social insurance programs and the percent of payroll for discretionary, privately-funded programs drops sharply. Government-mandated social insurance programs constitute 30 percent of Whirlpool's total benefit package cost.

Second, very few non-mandated programs ever escape taxation. For example:

- Pensions (and PAYSOPS) are taxed at distribution, as they should be, at the time retirees begin to receive the tangible financial benefit.

- Group life insurance is taxed for values which exceed $50,000.

- Rest periods are usually included in the normal 8-hour workday, and are, therefore, taxed as regular payroll.

- Vacations and holidays are part of the normal work cycle, and, like rest periods, their values are included in regular payroll already being taxed.

- Social Security and Medicare taxes are already assessed against the nation's workforce.

The Employee Benefit Research Institute estimates that only nine percent -- not 60 percent -- of the nation's payroll cost is tax favored. At Whirlpool, the ratio of benefits not being taxed is approximately 10.2 percent of payroll.

Despite these myth-shattering statistics, the urgency by a few special interest groups to tax benefits persists. Benefits taxation would constitute a complete reversal of the government's long-standing social objective to encourage growth of private benefit plans. To suddenly change public policy in midstream would be disruptive and invite dire consequences to the financial well-being of America's workforce.

How disruptive is highlighted in a recent survey by the employee benefits firm of Mercer-Meidinger. The report, entitled "Employer Attitudes Toward Employee Benefits and Tax Change," reveals important findings useful for Congress's deliberation:

1. Eighty-nine percent of employers studied report that eliminating tax preferences for employee benefits will have a negative effect on the health and welfare of workers and their families.

2. Eighty-seven percent agree that the current policy of providing favorable tax treatment for employee benefits should remain unchanged.

3. Eighty-one percent disagree that eliminating tax preferences for employee benefits is a sensible approach to increasing revenues.

4. Sixty-nine percent believe that favorable tax treatment has been influential in encouraging their company to sponsor employee-benefit plans.

5. Fifty-seven percent report that their company's benefit programs would be curtailed by 1990 if the tax status of employee benefits were to change.

The last two items are particularly informative and portend serious troubles ahead if Congress persists on its collision course and bias against employee benefits.

As one lawmaker put it: the more something is taxed, the less you get of it. If private programs lose favor because of tax reform and efforts to raise revenues, the government will necessarily need to shoulder more of the social and financial burden. In light of the government's past record of social programs management, America's workforce can scarcely take much comfort in that possibility.

Employer-provided benefit programs like Whirlpool's, over the long term, have reduced financial and social pressure on public sector programs like Medicaid/Medicare, Social Security and many other publicly funded programs. Overall, employer-funded programs have been administered fairly, in a cost-efficient, prudent manner and, left untouched by government, will continue to serve employees' and the nation's needs in the future.

We believe it would be a grave mistake for Congress to target these programs for new taxes because it would debilitate one of the financially strongest private sector employee programs in existence. At a time when more and more Americans are asking for a more limited role for government, we should look to the private sector to assume a greater role. Congress should support -- not discourage -- that effort by: 1) continuing to grant favorable tax treatment of employee benefits and, 2) by developing a uniform national policy on the role of private sector benefit programs. There has been no clear direction or consistent treatment of this matter. Over the last 10 years, for example, Congress has deliberated on at least five different approaches to employee benefits. We propose that Congress and the Administration provide this needed direction by identifying the role and proper relationship of private to public programs -- to be accomplished in the context of a free market system.

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ADDENDUM

Double Taxation Unfair

Over the years, shareholder dividends have been unfairly subjected to double taxation: once when included in the before-tax amount on earnings; then again as income to individual shareholders (except for minor exclusionary amounts).

The President's reform proposal would begin to remedy this discriminatory provision of the tax code by allowing a corporate deduction of 10 percent of dividends paid to shareholders. We endorse that provision as a first step, hopefully, to eventually eliminate all double taxation of dividends and to rechannel these scarce financial resources into badly needed capital investments and jobs creation.